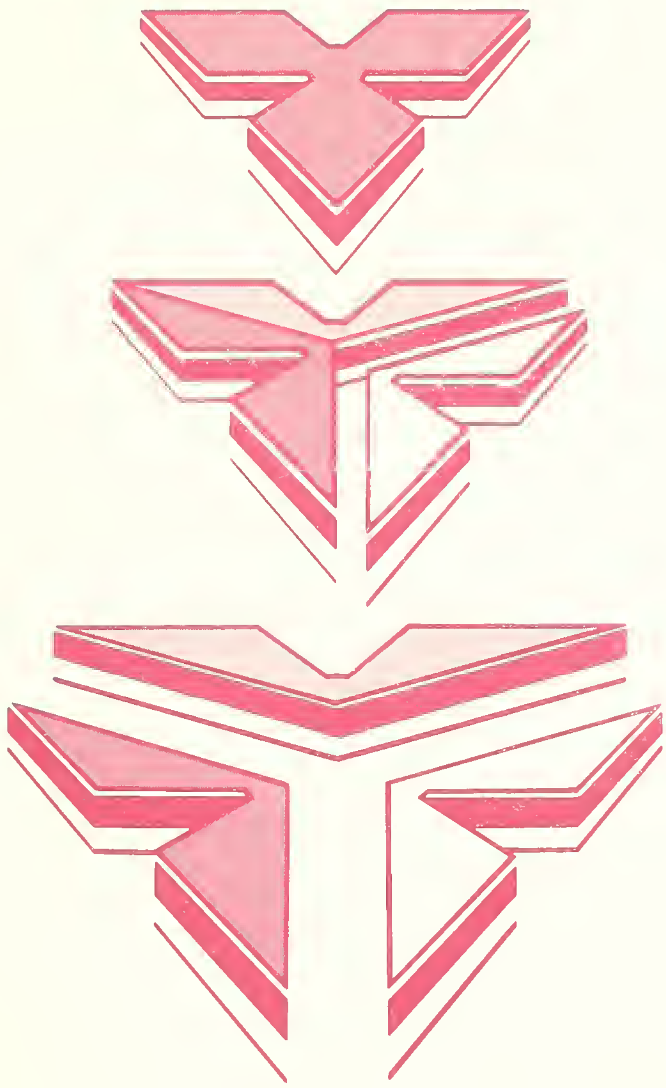

In whose interest?

Ontario

Task Force on the Investment of Public Sector Pension Funds

ERRATA

IN WHOSE INTEREST? ROWAN TASK FORCE REPORT ON
THE INVESTMENT OF PUBLIC SECTOR PENSION FUNDS

Page x, line 6

Delete reference to "Chronologies of key events relating to seven major pension plans".

Page 14

Recommendation 7.3 should read as follows:

The net cash flow of the TSF should be invested in market investments beginning in 1989: 20 per cent in the first year, 50 per cent in the second year, and 100 per cent in the third and subsequent years.

Page 254, Figure 13.8 WCB - Current Practice

The area under "Investment Policy" labelled "Market Investments" should not be shaded.

Ontario

Task Force on the Investment of Public Sector Pension Funds

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Ontario

Task Force on the
Investment of
Public Sector Pension Funds

101 Bloor Street West
5th Floor
Toronto, Ontario
M5S 1P7
(416) 963-3613

November, 1987

The Honourable Robert F. Nixon
Treasurer of Ontario
7th floor
Frost Building South
7 Queen's Park Crescent
Toronto, Ontario
M7A IY7

Dear Treasurer:

In accordance with the terms of reference give to me on September 24, 1986, I am pleased to submit my Report.

Yours sincerely,

Malcolm Rowan

Malcolm Rowan
Chairman

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Research Report #1:	The Nature of the Pension Agreement, Frank Russell Canada Inc., 1987. ISBN 0-7729-2983-1 $6.50
Research Report #2:	Pension Fund Structure, William M. Mercer Limited, 1987. ISBN 0-7729-2984-X $12.00
Research Report #3:	A Comparison of Private and Public Sector Pension Plans, William M. Mercer Limited, 1987. ISBN 0-7729-2985-8 $10.50
Research Report #4:	Market vs. Non-Market Investments, Andersen Economic Research Ltd., 1987. ISBN 0-7729-2986-6 $6.50
Research Report #5:	Public Sector Pension Funds and the Capital Markets; John Bossons and John Todd, 1987. ISBN 0-7729-2987-4 $10.50
Research Report #6:	Venture Investing and Prudence, Venture Economics Canada Limited, 1987. ISBN 0-7729-2988-2 $9.00
Research Report #7:	Canada Pension Plan Fund: Options for Ontario, Blue Apple Consulting Inc., 1987. ISBN 0-7729-2989-0 $10.50

PREFACE

Introduction

Interest in pensions is at an all time high. The economic power of pension funds is increasingly appreciated and sought after. Public sector pension funds are not immune from these pressures.

Ontario's public sector pension funds have over $37 billion in assets and an annual cash flow of about $4.7 billion. In addition, the Canada Pension Plan (CPP) produces a potential annual cash flow for the Ontario Government of over $1 billion. How these funds are invested is important for the retirement security of many Canadians and for the vitality of the economy.

Terms of Reference

Our terms of reference required us to focus on two main areas:

- Ontario's public sector pension system, with special emphasis on seven funds
- Ontario's borrowings from the Canada Pension Plan.

Specifically, we were asked:

1. to examine public sector pension funds in Ontario:

   a) to determine whether the current methods and approaches to the investment of such funds in Ontario most appropriately meet the needs of the present and future pension beneficiaries in today's economic and financial environment

   b) to determine whether economic development in Ontario could be increased through changes to the way public sector pension funds are invested

   c) to identify the investment options available.

2. to review the experience and practices of other jurisdictions with respect to the investment of public sector pension funds.

3. to recommend changes, as appropriate, with special emphasis on the major pension pools, including the Teachers' Superannuation Fund (TSF), the Public Service Superannuation Fund (PSSF), the Superannuation Adjustment Fund (SAF), the Hospitals of Ontario Pension Plan (HOOPP), the Workers' Compensation Board (WCB) Pension Fund, the Ontario Municipal Employee Retirement System (OMERS), and the Ontario Hydro Pension Fund.

4. to examine the way in which Canada Pension Plan (CPP) funds are utilized and invested.

During the course of our work, a number of people anticipated we would audit the investment management practices of particular pension funds.

We did not, for two major reasons:

- First, by and large the investment performance of public sector pension funds is as good as private sector funds
- Second, the ongoing responsibility for investment management rests with a fund's board of governors. As such, we felt it is of primary importance to ensure the best board of governors is in place and that the pension deal in effect is clearly understood.

Our focus has been on the principles, structure and processes of pension fund investment management, not its mechanics.

Occupational pension plans are part of a total post retirement income system. Some people believe that the only way to provide adequate post retirement income is to redesign the whole system. That was not our mandate.

Study Logic

A pension plan is made up of many elements. The mandate of the Task Force was to examine public sector pension plans from an investment point view.

By and large, our recommendations are founded on an economic logic within the prevailing legal framework. An important outcome of our work is a framework within which to evaluate public sector pension funds and the aspirations of stakeholders.

Before we could comment on the investment of public sector pension funds it was necessary to determine in whose interest pension fund investments are made. This in turn led us to examine what came to be a key issue: "What is the pension deal?" The "deal" was defined as the statement of the pension promise by an employer, and the means by which that promise will be fulfilled.

We found that different basic assumptions and imperfect understandings about the nature of the pension deal result in fundamental disagreements. For some, the debate centres around what a pension plan ought to be. For others, it centres around what a pension plan is. We have tried to acknowledge as many of these points of view as possible.

Structure of Report

This report is written for the person who knows little about occupational pension plans or the Canada Pension Plan. It is structured in six parts:

- Chapters 1 and 2 provide an overview of Ontario's public sector plans and the issues
- Chapters 3 through 5 review the various kinds of pension deals and the basic principles underlying each kind of deal
- Chapters 6 through 13 is the application of those principles to seven funds
- Chapter 14 relates to the Canada Pension Plan
- Chapter 15 sets out the consequences for implementation of our recommendations

- Chapter 16 makes some concluding comments and identifies some pension trends.

Our recommendations should be of interest to a number of audiences, including:

- government, in its role as:
  - employer/pension plan sponsor,
  - the rule maker of the pension system
- boards of governors of public sector pension plans
- public service employees and employee representatives
- the general public who as taxpayers help fund public sector plans
- private sector employers and employees.

Stakeholders

Many individuals and groups have a stake in the way public sector pension funds are invested. Some have a larger stake than others. Of these stakeholders only two – taxpayers and plan participants – are principals. The rest are agents of one kind or another.

Study Process

Our first task was to develop a data base on Ontario's public sector pension system. This we did by means of questionnaires, by examining printed material and by contacting those responsible for many of the plans.

We then commissioned a number of research reports covering such areas as:

- the nature of the pension deal
- pension fund structure
- a comparison of public and private sector pension funds
- a review of non-market and market investments
- the impact of pension fund investing on the capital market
- venture investing
- the Canada Pension Plan.

These research reports have been published as background to our main report. The reader should refer to them for greater detail.

In all, we received 64 briefs from individuals and organizations.

We met with many stakeholders and others to explain our terms of reference and to seek their views. We also visited other jurisdictions in Canada and in the United States to learn from their experience. In June, 1987 we held a seminar at the Niagara Institute with a cross section of stakeholders and others just prior to writing our report.

Finally, we produced a number of unpublished reports covering such topics as:

- Trends in pensions and post retirement income
- A summary of briefs submitted to the Task Force
- A description of pension fund arrangements in other jurisdictions
- A summary of the legal documentation of seven public sector pension plans
- ~~Chronologies of key events relating to seven major pension plans.~~

Other Pension Perspectives

Others are looking at the pension system and the pension deal from different perspectives. To the extent possible, we have harmonized our work with theirs so as to minimize the problem for the Government of having to deal with recommendations based, explicitly or implicitly, on different principles.

We are aware that some are concerned about the increasing concentration of the power to make investment decisions which now resides with pension funds and other institutional investors. This is an issue which has implications broader than our mandate in that it involves private sector pension funds, mutual funds and registered retirement savings plans. As such, we have not ventured into this area.

Acknowledgements

Without exception we received the utmost co-operation and assistance. We are indebted to too many for us to list. We are particularly grateful though to the participants in our Niagara Institute Seminar for sharing with us their insights.

SUMMARY AND RECOMMENDATIONS

MAJOR CONCLUSIONS

1. $16.7 billion or 45 percent of all public sector pension fund assets are invested in non-market government debt and at rates of return below that which could be achieved if invested in a diversified portfolio of market investments.
2. Ontario taxpayers could potentially benefit by at least $1.2 billion over a period of 10 years if the Teachers' Superannuation Fund (TSF), the Public Service Superannuation Fund (PSSF), the Superannuation Adjustment Fund (SAF) and Ontario's Canada Pension Pan (CPP) funds were invested in market investments.
3. Economic enhancement can best be achieved if public sector pension funds are invested in the capital market.
4. The taxpayer's interest is not adequately taken into account in a number of public sector pension funds.
5. Ontario's public sector pension system is already highly centralized with six funds accounting for 84 per cent of total assets.
6. With some exceptions, the current methods and approaches to the investment of public sector pension funds meet the needs of present and future pension beneficiaries.
7. Investment performance of Ontario public sector pension funds is comparable to that of private sector pension funds.
8. Over 2,000 employers, more than 530,000 employees, 130,000 pensioners, 86 pension funds and assets of $37 billion comprise Ontario's public sector pension system.
9. The annual cash flow of Ontario's public sector pension funds is about $4.7 billion. Ontario's CPP borrowing entitlement amounts to an additional $1 billion.

MAJOR RECOMMENDATIONS

1. TSF, PSSF and SAF assets should be invested in market investments.
2. The TSF, PSSF and OMERS pension deals should be changed so that the taxpayer's interest is better represented.
3. Public sector pension fund investment should not be further centralized.
4. The Government should not direct public sector pension funds to make particular kinds of investments.
5. The TSF and PSSF should be established as separate arms-length pension funds.
6. The SAF should be merged with the TSF, PSSF and RYERSON pension funds.
7. Public sector funds should be governed by the same rules as private sector funds.
8. Plan members should participate in pension fund decision-making.
9. The cost of pension benefits should be assessed in a total compensation context.
10. An Ontario CPP Fund should be established to invest Ontario's CPP funds in market investments.

The Task Force's Review

Our terms of reference required us to focus on two main areas:

- Ontario's public sector pension system, with particular emphasis on seven funds
- Ontario borrowings from the Canada Pension Plan.

Our recommendations are designed:

- to bring a more market-oriented, less paternalistic, approach to public sector pension funds
- to segregate more clearly public sector pension fund assets from general government revenues where this is not now the case
- to emphasize that pensions are part of total compensation and should not be dealt with in isolation
- to clarify government roles and responsibilities with respect to public sector pension funds
- to put employee and employer expectations into better perspective so that they can be assessed
- to enhance plan member involvement in pension fund decision-making
- to ensure the taxpayer's interest is recognized and acted upon
- to retain diversity in pension fund investment management
- to change the way Ontario views CPP funds from a captive borrowing source for government to a source of savings to be invested in the economy as a whole.

Implementation of our recommendations will give the public sector pension system greater flexibility and thereby enable it to adapt more quickly and with less stress to the needs of the times.

Ontario's Public Sector Pension System

There are 86 public sector pension plans in Ontario's public sector pension system with over $37 billion of assets, over 2,000 employers, over 530,000 active plan members and 130,000 pensioners.

Our mandate was to examine that system from an investment point of view and, in particular, to examine in depth the following seven large public sector pension funds:

- the Teachers' Superannuation Fund (TSF)
- the Public Service Superannuation Fund (PSSF)
- the Superannuation Adjustment Fund (SAF)
- the Ontario Municipal Employees Retirement System (OMERS)

- the Ontario Hydro Pension Fund (HYDRO)
- the Hospitals of Ontario Pension Plan (HOOPP)
- the Workers' Compensation Board (WCB).

Our first question was: "In whose interest are pension fund investments made?" This in turn led us to examine what came to be a key issue: "What is the pension deal," i.e. what is the employer's pension promise to his employees?

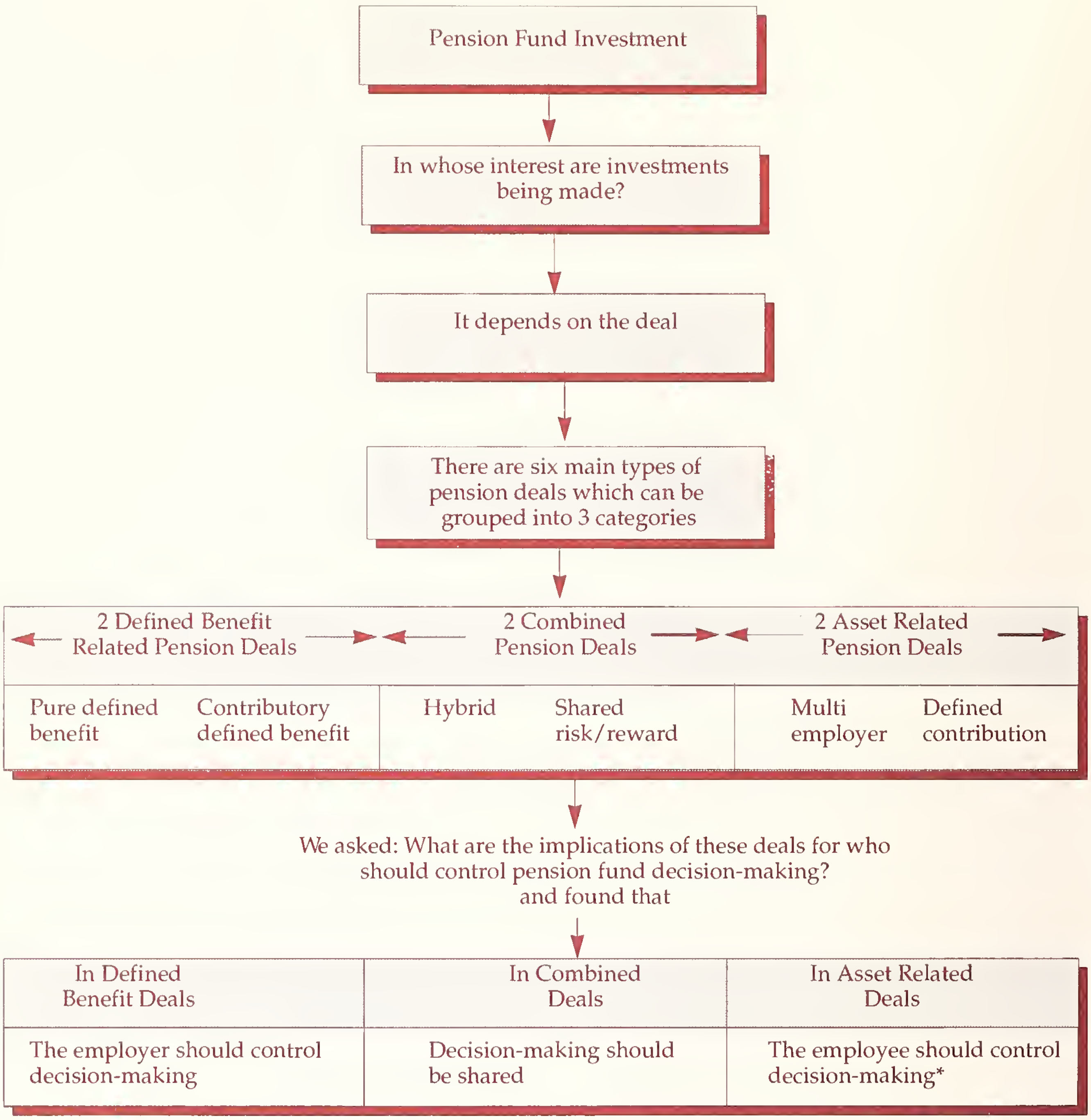
We found that a pension deal has eight main components:

- membership criteria
- benefits policy
- funding policy
- ownership of a surplus (deficit)
- pension fund structure and control
- investment policy
- plan administration
- changing the pension deal.

In examining these components, we found that many were interrelated and that it was impossible to discuss pension fund investment without appreciating these relationships. It also became apparent that these relationships differed, depending on the kind of pension deal we examined.

From this we developed the following logic.

Pension Fund Study Logic



* In practice, the employer sets the framework; the employee chooses from a limited number of options.

Of the six types of pension deals, all except the asset related multi-employer deal are operative in the public sector.

Nine characteristics

Nine characteristics of Ontario's public sector pension system stand out. For most of these, the closer one gets to the Government itself, the more apparent these characteristics are. They are as follows:

- A paternalistic, "trust me" philosophy
- Employee concerns about the paternalistic philosophy
- Employees demanding more say in pension fund decision-making
- Blurring of roles and responsibilities

- Lack of a total compensation context
- Lack of a bottom line discipline
- Unrealistic expectations by many employees and employers
- Diversity of pension arrangements
- Good investment management

Major Issues

In light of our analysis, we identified nine issues. Many were raised in the 64 briefs we received. Others emerged from discussions we held with diverse groups.

- What is the pension deal, and what processes exist for changing it?
- Who controls pension fund decision-making?
- Pension fund structure: should it be centralized or decentralized
- Investment policy: market vs. non-market investments?
- Who owns a pension fund surplus (deficit)?
- Accountability: for what, to whom?
- Roles of Government: their relevance for pensions?
- What is the taxpayer's stake and how well is it protected?
- Should Canada Pension Plan funds be invested in market investments?

Principles and Conclusions

We examined each of these issues to determine whether there were any general principles or conclusions which could be applied to the seven pension funds we were asked to examine in detail.

Public Sector Pension Deals

When we examined Ontario's 86 public sector pension deals we found:

- Forty-nine of the 86 are defined benefit related deals, 11 are combined deals, and 26 are asset related deals.
- Their investment performance is as good as private sector funds.
- A fund's size and investment management, whether internal or external, do not appear to affect its performance; but its investment policies (i.e. decisions on level of risk and mix of assets) do.
- Combined assets total $37 billion. The ten largest funds have 90 per cent of the assets.
- Defined benefit related deals account for approximately 95 per cent of the assets.

- None of the 86 funds had a deficit, although the Superannuation Adjustment Fund, which involves a partial pay-as-you-go deal, has large unfunded future obligations.
- 55 per cent of the assets are invested in market investments, the rest is invested in non-market government debt.
- Pensions are a part of total compensation.

Pension Fund Decision-making

We found that:

- Who controls pension fund decision-making is normally determined by the nature of the pension deal.
- For the most part, decision-making in defined benefit plans is controlled by the employer.
- For defined contribution deals, decision-making rests with the employee in principle, although in practice most decisions are made by the employer.
- For combined deals, decision-making is shared.
- Both employers and employees have a stake in pension fund/plan management. The extent of that stake is linked to the kind of pension deal.
- Plan members should be involved in pension fund decision-making.

Pension Fund Structure

We conclude that:

- Pension funds should be established so that, to the extent practical, they are clearly separated from the employer and plan members.
- Public sector pension funds should not be further centralized.
- Smaller funds should be encouraged to pool their assets with a larger fund for reasons of economy and the potential to invest in a more diversified portfolio.
- Better methods for changing many public sector pension deals are needed.
- A pension fund governor should represent neither the employer nor the plan members but has a fiduciary responsibility to all fund beneficiaries.
- Who a pension fund's beneficiaries are depends on the deal, but can include active plan members, pensioners, former employees with deferred pensions and the employer (if entitled to part or all of a surplus).

Investment Policy

We conclude that:

- The assets of public sector pension funds should be invested in market investments.
- The investment policy for public sector pension funds should be determined by the fund governors, in the context of the pension deal and the nature of the liabilities.

- Pension funds can best foster economic enhancement through the capital market. Non-economic investments should be supported by government programs, not by public sector pension funds.
- Public sector pension funds should not make investments which sacrifice investment return for other objectives.
- The foreign property limit in the Income Tax Act (Canada) should be increased above 10 per cent.

Pension Fund Surplus (Deficit)

We conclude that:

- A surplus can have two parts: an investment risk surplus and an actuarial surplus.
- The ownership of a pension fund's surplus is determined by the nature of the pension deal.
- For the most part, an investment risk surplus in a defined benefit related deal is owned by the employer, for defined contribution (or asset related) deals it is owned by the employee, and for combined deals ownership is shared.
- An actuarial surplus in a contributory defined benefit related deal may result from over-contributions by both the employee and the employer.
- Who owns a surplus (deficit) must be clear in order to know in whose interest investment decisions are made.

Accountability

We conclude that:

- The accountability of those responsible for public sector pension funds should be improved through better and more understandable reporting and information to plan members, the public, and the Pension Commission of Ontario.

Roles of Government

Government in its employer role should:

- Be governed by the same rules as private sector employers.
- Act as the employer when it is the employer and not confuse its legislative role with its role as employer.

Seven Pension Funds

Having identified these general principles and conclusions, we then applied them to the seven pension funds we were asked to examine in detail.

Teachers' Superannuation Fund (TSF)

We conclude that:

- Aspects of the current teachers' pension deal should be changed if both parties want to retain a contributory defined benefit related deal.
- TSF assets should be invested in market investments.
- A separate investment agency at arms length from the Government should be established with its own Board, including a minority of plan members.
- Any investment risk surplus should benefit the taxpayer.
- The Government should discuss with teachers whether they want to replace their current defined benefit related deal with a shared risk/reward or defined contribution deal.
- A more direct link between salary negotiation and pension benefits should be forged.

Public Service Superannuation Fund (PSSF)

We conclude that:

- Aspects of the current public service pension deal should be changed if both parties want to retain a contributory defined benefit related deal.
- PSSF assets should be invested in market investments.
- A separate investment agency at arms length from the Government should be established, with its own Board, including a minority of plan members.
- Any investment risk surplus should benefit the taxpayer.
- The Government should discuss with public servants whether they want to replace their current defined benefit related deal with a shared risk/reward or defined contribution deal.
- A more direct link between salary negotiation and pension benefits should be forged.

Superannuation Adjustment Fund (SAF)

We conclude that:

- The SAF should be merged with the appropriate base funds so that its assets can be invested by those funds.
- The SAF funding policy should fairly apportion the cost of inflation indexation between current and future plan members and taxpayers.
- If the SAF is not merged, then a separate investment agency at arms length from the Government should be established with its own fund governors.

OMERS

We conclude that:

- Current practice is not consistent with the formal pension deal.
- There are two options:
  - change current practice
  - change the formal pension deal so that plan members share in the investment and actuarial risk as well as the investment and actuarial reward.
- The OMERS Board should decide whether it is in the business of offering investment and plan administration services to other plan sponsors and, if so, it should be held accountable for the quality of service offered.
- No change should occur in the OMERS/CAATS relationship without clarifying who is the CAATS employer for pension purposes.

Ontario Hydro

We conclude that:

- Ontario Hydro should review its pension fund structure with a view to establishing either a separate pension fund board of governors with a minority of plan members or appointing a minority of plan members to its planned investment policy committee.
- The Ontario Hydro pension plan and fund should be governed by the Pension Benefits Act and the specific provisions in the Power Corporation Act relating to the HYDRO Fund should be removed.
- Approval of the Lieutenant Governor in Council for benefit changes determined by collective bargaining is not necessary.

Hospitals of Ontario Pension Plan (HOOPP)

We conclude that:

- The employer/taxpayer is currently contributing too much to the HOOPP Fund.
- The Ministry of Health and the hospitals should sort out whether any benefit from lower employer contributions should result in lower hospital grants by the Ministry or whether the funds made available in this way should be used by the hospitals for other health care purposes.
- The Ontario Hospital Association should amend the HOOPP plan to provide that any surplus on plan termination should be refunded to employers.
- At least one non-management plan member representative should be appointed to the HOOPP Investment Committee.

WCB Pension Fund

We conclude that:

- Clearer separation of the WCB insurance and pension funds is essential for investment, fiduciary and accountability purposes.
- Employee involvement on WCB's Investment Advisory Committee for those matters involving the WCB pension fund is desirable.
- The process in government for approving WCB benefit and contribution rate increases should be streamlined.

Canada Pension Plan (CPP)

The CPP is a national, pay-as-you-go social insurance program. CPP contributions are a dedicated tax on all working Canadians and their employers. Since 1965, provinces have been entitled to borrow from the CPP Investment Fund on a pro rata basis relative to contributions. Ontario has borrowed about $16 billion or 46 per cent of the total fund.

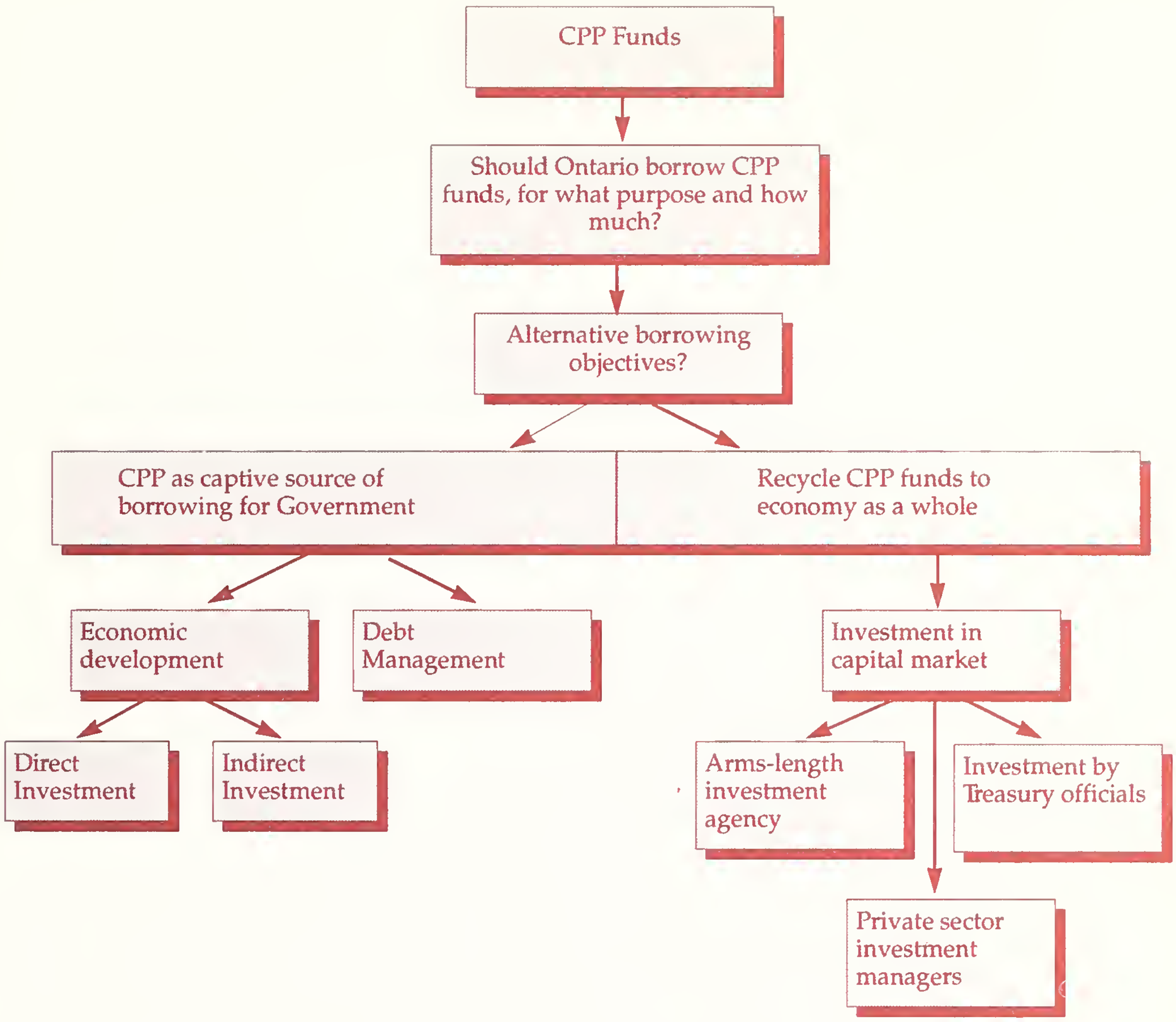
Our examination of the CPP focussed on whether Ontario should continue to use the CPP Investment Fund as a captive source of borrowing or should recycle CPP funds back into the economy as a whole through market investments.

Our logic is set out on page 11.

We conclude that:

- Ontario should not use the CPP Investment Fund as a captive borrowing source but should recycle CPP money back into the economy through the capital market.
- A new investment fund at arms length from the Government should be established to invest Ontario's CPP borrowing entitlement in market investments.
- Non-economic investments should be made through Government programs.
- If the Government needs to borrow funds for economic enhancement programs it should do so in the capital market in competition with the private sector rather than borrowing direct from the CPP.
- The investment of CPP funds in the capital market should be phased in over three years.
- By investing CPP money in the capital market, two objectives would be served: to invest in tangible, wealth-producing assets and to demonstrate a willingness by the Province to compete with the private sector for this important source of savings.

CPP Study Logic



Implementation

- The shift to market investments by the TSF and the PSSF should be phased over at least three years (1989-92) for net cash flow. Existing non-market investments should be reinvested in market instruments as they mature.

Taxpayers' Stake

We conclude that:

- By investing the assets of the TSF, PSSF and SAF and Ontario's CPP borrowing entitlement in market investments, the Ontario taxpayer could earn, on average, at least a 1 per cent additional risk related rate of return. Over a ten-year period, the cumulative additional investment earnings are conservatively estimated at $1.2 billion and could range up to $2.2 billion. This would likely increase as non-market government debt matures and is invested in market investments.

- The taxpayer's interest in some of the larger public sector plans is not adequately taken into account. A better balance should be sought.

Plan Members and Employers

We conclude that:

- the pension entitlements of plan members and pensioners are in no way affected by our recommendations.
- plan members and employers need to temper their expectations about their respective rights and obligations in relation to public sector pension funds.

RECOMMENDATIONS OF THE TASK FORCE ON THE INVESTMENT OF PUBLIC SECTOR PENSION FUNDS

THE PENSION DEAL

■ 3.1
Public sector employers should review their pension deal to determine whether the component of the deal relating to ownership of a surplus (deficit) is clear. Where this component is not clear, public sector employers should discuss changes to the deal with employees to make this component clear.

■ 3.2
Public sector employers should be amenable to discussing changes to the current pension deal with their employees if their employees indicate a desire for change.

■ 3.3
To the extent possible, benefit and employee contribution levels should be negotiated or discussed between the employer and employees as part of total compensation.

PENSION FUND STRUCTURE

■ 4.1
Public sector employers/plan sponsors should involve plan members in plan administration and investment management and, in appropriate circumstances, should appoint plan members as pension fund governors.

■ 4.2
Where the organizational structure of the pension fund in a defined benefit related pension deal is separate from the employer/plan sponsor (e.g. OMERS), a minority of the pension fund governors should be plan members.

■ 4.3
Where the organizational structure of the pension fund in a defined benefit related pension deal is not separate from the employer/plan sponsor (e.g. HYDRO, HOOPP and WCB), the employer/plan sponsor or the pension fund governors should appoint a minority of plan members to its investment committee.

■ 4.4
To the extent practical, public sector pension funds should be organized so that their activities are clearly separated from the employer and the employees.

■ 4.5
The Government should not further centralize public sector pension funds. The existing large funds should continue to operate as separate and independent funds.

■ 4.6
The Government should encourage smaller public sector pension funds to pool their assets for investment purposes with a larger public sector pension fund so that they can benefit from lower investment management costs and potentially more diversified investment opportunities.

■ 4.7
The decision to select and appoint internal or external investment managers for public sector pension funds should rest with pension fund governors.

■ 4.8
Public sector pension funds should review their compensation policies for their internal investment managers with a view to ensuring that they are in line with the compensation policies for internal investment managers of private sector pension funds.

INVESTMENT POLICY

■ 5.1
Public sector pension fund sponsors should ensure that a formal process of holding pension fund governors accountable is in place.

■ 5.2
As an instrument of accountability, public sector pension fund governors should provide full information about the fund annually to plan members, and should make this information available publicly for the benefit of the taxpayer.

■ 5.3
As a matter of principle, public sector pension funds should invest only in market investments.

■ 5.4
Subject to appropriate phasing-in periods for both cash flow and existing non-market government debt, the TSF, PSSF and SAF should invest only in market investments.

■ 5.5
The Government should not direct public sector pension funds to make investments which are not in the financial interest of the funds and their beneficiaries.

■ 5.6
The Government should request the Federal Government to raise the foreign property limit contained in the Income Tax Act above 10 per cent.

TSF

■ 7.1
The Teachers' Superannuation Fund be established at arms length from the Government and teachers, with its own board responsible for investment management and appointed by the Lieutenant Governor in Council. A minority of board members should be plan members or their representatives.

■ 7.2
The TSF should be invested in market investments.

■ 7.3
The net cash flow of the TSF should be invested in market investments beginning in 1989: 20 per cent in the first year, 50 per cent in the second year, and 200 per cent in the third and subsequent years.

■ 7.4
Non-market government debentures held by the TSF should be re-invested in market investments as they mature.

■ 7.5
Concurrent with a shift to market investments, the investment policy of the TSF should be changed to one which maximizes the return to the TSF at an appropriate level of risk.

■ 7.6
If the taxpayer remains liable for any deficit in the TSF, the Government should seek to change the teachers' pension deal so that the taxpayer benefits from any investment risk surplus in the TSF.

■ 7.7
The Government should seek to change the teachers' pension deal so that:

- teachers can benefit from that part of an actuarial surplus in the TSF that results from their over-contributions, and

- the taxpayer can benefit from the remainder of an actuarial surplus in the TSF.

■ 7.8
The Government should initiate discussions with the Ontario Teachers' Federation to begin the process of merging the assets and liabilities of the TSAF with the TSF.

■ 7.9
The Government should initiate discussions with teachers and their representatives to see if they wish to retain their current defined benefit related deal or have a new pension deal – for example, a shared risk/reward deal or a defined contribution deal.

■ 7.10
The Government should establish a direct and clear link between salary negotiations and pension benefit discussions so that the total compensation paid to teachers can be revealed to teachers and taxpayers alike and appropriate trade-offs considered in a more explicit way.

PSSF

■ 8.1
The PSSF be established at arms length from the Government and public servants, with its own board responsible for investment management and appointed by the Lieutenant Governor in Council. A minority of board members should be plan members or their representatives.

■ 8.2
The PSSF should be invested in market investments.

■ 8.3
The net cash flow of the PSSF should be invested in market investments beginning in 1989: 20 per cent in the first year; 50 per cent in the second year; 100 per cent in the third and subsequent years.

■ 8.4
Non-market government debt held by the PSSF should be reinvested in market investments as it matures.

■ 8.5
Concurrent with a shift to market investments, the investment policy of the PSSF should be changed to one which maximizes the return to the PSSF at an appropriate level of risk.

■ 8.6
If the taxpayer remains liable for any deficit in the PSSF, the Government should seek to change the public service pension deal so that the taxpayer benefits from any investment risk surplus in the PSSF.

■ 8.7
The Government should seek to change the public servants' pension deal so that:

- public servants can benefit from that part of an actuarial surplus in the TSF that results from their over-contributions, and
- the taxpayer can benefit from the remainder of an actuarial surplus in the TSF.

■ 8.8
The Government should initiate discussions with public servants and their representatives to begin the process of merging the assets and liabilities of the PSSAF with the PSSF.

■ 8.9
The Government should establish a direct and clear link between salary decisions and pension benefit decisions so that the total compensation paid to public servants can be revealed to public servants and taxpayers alike, and appropriate trade-offs considered in a more explicit way.

■ 8.10
The Government should initiate discussions with public servants and their representatives to see if they wish to retain their current deal or have a new pension deal – for example, a shared risk/reward or a defined contribution deal.

SAF

■ 9.1
The Management Board of Cabinet should initiate discussions with the three SAF Review Committees with the object of developing a funding policy for the TSAF, the PSSAF and the RSAF which fairly apportions the cost of inflation indexation between current and future plan members and taxpayers.

■ 9.2
The appropriate assets of the SAF should be merged with the TSF and PSSF once these funds have been established as arms-length investment agencies, as per Recommendations 7.1 and 8.1, and a more realistic inflation indexation funding policy is in place. Similarly, the RSAF assets should be merged with the Ryerson fund once a more realistic inflation indexation funding policy is in place.

■ 9.3
Subject to Recommendation 9.1, the net cash flow of the three SAF funds should be invested in market investments as part of the TSF, PSSF and Ryerson fund, beginning in 1989: 20 per cent in the first year, 50 per cent in the second year and 100 per cent in the third and subsequent years.

■ 9.4
Subject to Recommendation 9.1, non-market government debt held by the SAF should be reinvested in market investments as it matures, through the TSF, PSSF and Ryerson fund.

■ 9.5
Concurrent with a shift to market investments and with a merger of the three SAF funds with the TSF, PSSF and Ryerson fund respectively, the investment policies of the merged funds should maximize the return to the base funds at appropriate levels of risk.

OMERS

■ 10.1
The Government initiate discussions designed to bring the formal OMERS pension deal into line with current practice but with an explicit sharing of risks and rewards between employer/contributors and plan members.

■ 10.2
As an alternative to Recommendation 10.1, current practice in the OMERS pension deal should be changed to bring it into line with the formal OMERS pension deal.

■ 10.3
The Ministry of Colleges and Universities, the Council of Regents and the Boards of Governors of the Colleges of Applied Arts and Technology (CAATS) should clarify their different roles and responsibilities with respect to the CAATS pension deal in order to confirm, among other things, who is the employer for pension purposes, who is the plan sponsor and who is responsible for unfunded liabilities.

■ 10.4
No change be made in the contractual relationship between OMERS and the CAATS respecting either plan administration or investment management until:

a) Recommendation 10.3 has been completed, and

b) The cost implications of the proposed changes have been assessed.

■ 10.5
The Government should clarify whether Section 16 of the OMERS Act (under which OMERS carries out plan administration and investment management functions for CAATS and RYERSON) is permissive or mandatory. If mandatory, then the Government should set out to whom the OMERS Board is accountable in this respect and how its performance should be measured.

■ 10.6
If Section 16 of the OMERS Act is permissive, the OMERS Board should determine whether OMERS wishes to supply plan administration and investment management services to other public sector pension funds. If it wishes to supply such services, the OMERS Board must be prepared to give direction and support to OMERS staff so that they can provide high quality and competitive service.

HYDRO

■ 11.1
Ontario Hydro should review its pension fund structure:

- If a separate board is established to be responsible for the investment management of the Ontario Hydro pension fund, a minority of board members should be plan members or their representatives.
- If a separate board is not established, a minority of committee members on the planned pension investment policy committee should be plan members or their representatives.

■ 11.2
The Ontario Hydro pension fund should be governed by the Pension Benefits Act. The specific provisions in the Power Corporation Act covering the HYDRO Fund, apart from any necessary enabling provisions, should be removed.

■ 11.3
The requirement for approval by the Lieutenant Governor in Council of changes in pension benefits for Ontario Hydro employees should be removed.

HOOPP

■ 12.1
The Ministry of Health and the Ontario Hospital Association should determine whether any savings arising from reduced employer contributions to the HOOPP pension fund should remain in the health care system for non-pension uses or should benefit the taxpayer through a reduction in grants to hospitals.

■ 12.2
The Ontario Hospital Association should amend the HOOPP plan to provide that any surplus on plan termination is refunded to employers.

■ 12.3
The Ontario Hospital Association appoint at least one non-management plan member or representative to the HOOPP Investment Committee.

WCB

■ 13.1
The WCB should review its pension fund structure:

- If a separate board is established to be responsible for the investment management of the WCB pension fund, a minority of board members should be plan members or their representatives.
- If a separate board is not established, a minority of committee members on the Investment Advisory Committee should be plan members or their representatives for those matters involving the WCB pension fund.

■ 13.2
The WCB Board, the Investment Committee and the Investment Advisory Committee should make a clear separation in their decisions between the WCB accident fund and the WCB pension fund.

■ 13.3
The decision-making process within the Ontario Government for considering changes to WCB pension benefit levels should be streamlined.

CPP

■ 14.1
The Ontario Government should borrow its entire CPP borrowing entitlement for reinvestment in the capital market in order to increase economic efficiency and foster economic growth.

■ 14.2
The Government should not borrow captive CPP funds to subsidize economic development projects or programs. If the Government wishes to undertake economic development projects and needs to borrow to finance them, this borrowing should be done in the capital market in competition with the private sector.

■ 14.3
An Ontario CPP Fund should be established at arms length from the Government, with its own board appointed by the Lieutenant Governor in Council and responsible for the investment through the capital market of monies borrowed by Ontario from the CPP Investment Fund.

■ 14.4
The Board of Governors of the Ontario CPP Fund should determine the investment policy for monies borrowed by Ontario from the CPP Investment Fund and reinvested in the capital market.

IMPLEMENTATION

■ 15.1
The implementation of the Task Force's recommendations be divided into at least six phases including:

- a public review and comment phase
- a legislation preparation and approval phase
- an organizational phase
- three investment phases over a three-year period

■ 15.2
The primary responsibility of issues related to the implementation of recommendations for specific public sector pension plans should be delegated to the Ministry most closely connected to the employer/plan sponsor for each plan.

■ 15.3
The Government should assign to a central agency, preferably Cabinet Office, the overall responsibility to co-ordinate the activities of individual ministries affected by the Task Force's recommendations and to receive comments on those recommendations.

CHAPTER 1

ONTARIO'S PUBLIC SECTOR PENSION PLANS AND FUNDS

SYNOPSIS

About 2,000 employers and 530,000 employees participate in 86 Ontario public sector pension plans. The combined assets of the 86 pension funds at December 31, 1986 were $37 billion. Six funds have 80 per cent of the assets and the largest 20 funds have 95 per cent of assets. Forty-five per cent of the assets are invested in non-market government debt. Where internal or external investment managers have discretion, the investment policies and investment performance of Ontario's public sector pension funds are indistinguishable from private sector pension funds. Investment performance does not appear to be influenced by fund size or by the use of internal vs. external investment managers. Differences in investment policy do affect investment performance.

Introduction

This chapter introduces Ontario's public sector pension plans and funds. It provides the context for the analysis and discussion in later chapters.

The chapter is divided into four sections:

I. **Public Sector**

II. **Overview**

III. **Investments**

IV. **Practices and Policies**

SECTION I

Public Sector

A public sector pension plan is:

- a pension plan established by an employer who is classified as being in the public sector

A public sector pension fund is:

- the funding medium by which the liabilities of a public sector pension plan are paid or provided for, including plan assets.

Our definition of the public sector is based on functional tests contained in the Public Sector Prices and Compensation Review Act, 1983 and includes:

- core public sector
- municipalities
- school boards, universities and colleges
- hospitals
- crown-owned corporations with share capital
- crown-owned corporations without share capital
- boards of health
- the Ontario Legislature and other institutions independent of government

Staff of the Task Force and of the Pension Commission of Ontario collaborated in identifying 99 public sector pension plans. Thirteen of these, which together cover only 155 employees, are annuity purchase plans and do not accumulate assets. Therefore, our Report covers only the 86 pension plans which have funds.[1]

The Task Force's principal source of data was responses to a questionnaire. Published material, briefs submitted and interviews also provided information on some of the large plans.

Many respondents provided detailed information about their pension plans and funds. Some, however, were unwilling or unable to complete the questionnaire. Follow-up telephone contact and alternative information sources were used where possible in an attempt to improve the Task Force's database. Gaps do remain for certain funds. Consequently, some of the tables and charts in the Report do not contain information from all 86 public sector pension funds.

Furthermore, given the wide range of pension deals and the inherent differences in the way information is gathered and disseminated, certain data is subject to interpretation and clarification.

Because the questionnaire was mailed out in 1986, the Task Force requested and received information as at December 1985. This information has been partially updated. Asset related information was updated for 1986 for all funds. Other key information was also updated for the seven funds specifically mentioned in our terms of reference.

The fact that not all information has been updated does not limit the scope, findings and conclusions of our report.

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[1] A more detailed explanation of our definition is contained in Appendix B. A catalogue of the public sector pension plans identified from our definition appears in Appendix C.

SECTION II

Overview

Figure 1.1 compares Ontario's public sector and private sector pension plans in terms of number of plans and plan members. Public sector pension plans account for less than 1 per cent of all pension plans in Ontario, but they have one-third of all plan members and at least one-third of all fund assets.[2]

Public and Private Sector Pension Plans in Ontario ~ 1986

FIGURE 1.1

Figure 1.2 provides some basic information about Ontario's public sector pension funds.

Ontario's Public Sector Pension System ~ 1986

FIGURE 1.2

[2] Public sector funds may have larger assets per member than private sector funds because combined employer and employee contribution rates (and benefits) are higher on average in the public sector. See *A Comparison of Private and Public Sector Pension Plans,* Research Report #3, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987).

About 2,000 public sector employers provide pension benefits to almost 530,000 public sector employees through 86 pension plans. An estimated 130,000 pensioners are currently receiving pension benefits from these plans.

Of these 86 public sector pension plans, 49 are defined benefit related plans, 26 are defined contribution plans and 11 are combined defined benefit/asset related plans.[3]

As of December 31, 1986, the market value of the assets of these 86 plans totalled $37 billion.[4]

Employers/Plan Sponsors/Employees

There is a wide variation in the design of public sector pension plans.

In some cases, the employer is the plan sponsor and contributor. HYDRO is an example.

In other cases, the employer is not the plan sponsor but is the contributor. HOOPP and OMERS are examples.

In still other cases, the employer is neither the plan sponsor nor the contributor. The TSF is an example. Some plans have many participating employers. OMERS is an example. Other plans have only one employer. HYDRO is an example.

Some employers sponsor different plans for different employee groups. This is common in university-sponsored plans.

There are about 20 times more employers than there are pension plans, suggesting that Ontario's public sector pension arrangements are quite centralized. Over 1,700 employers, or 86 per cent of all employers, are represented in three plans – OMERS, TSF and HOOPP. The 10 largest plans (by number of employees) represent about 1,800 employers, or 90 per cent of all employers, and have about 484,000 employees, or about 93 per cent of all employees.

Figure 1.3 sets out the number of employers, the plan sponsors, the employer/contributors and the number of active plan members for the 10 largest plans by number of active plan members.

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[3] See Chapter 3 and Appendix C for a full discussion on these types of plans.

[4] Some assets are invested in non-market government debt and are at book value. If an imputed market value is calculated for these assets, the market value for the 86 funds would amount to $39 billion at December 31, 1986.

Ontario's Ten Largest Public Sector Pension Plans by Number of Active Plan Members
December 31, 1986

Pension Plan	Employers	Plan Sponsor	Employer/ Contributors	Active Plan Members
TSF	361	Province	Province, Private Schools and Others	140,639
OMERS	1,069	Province	Municipalities & Local Agencies	140,120
PSSF	33	Province	Province & Various Boards	77,294
HOOPP	301	OHA	Hospitals & Other Health Institutions	70,478
HYDRO	1	Ontario Hydro	Ontario Hydro	23,542
CAATS	22	Council of Regents	Community Colleges	15,655
TTC	2	TTC Pension Fund Society	TTC & Union	9,400 *
University of Toronto	1	U of T	University of Toronto	6,085 *
WCB	9	WCB	WCB	4,090
SAF	**	Province	Province, Ryerson & Others	***
TOTAL	**1,799**			**487,303**

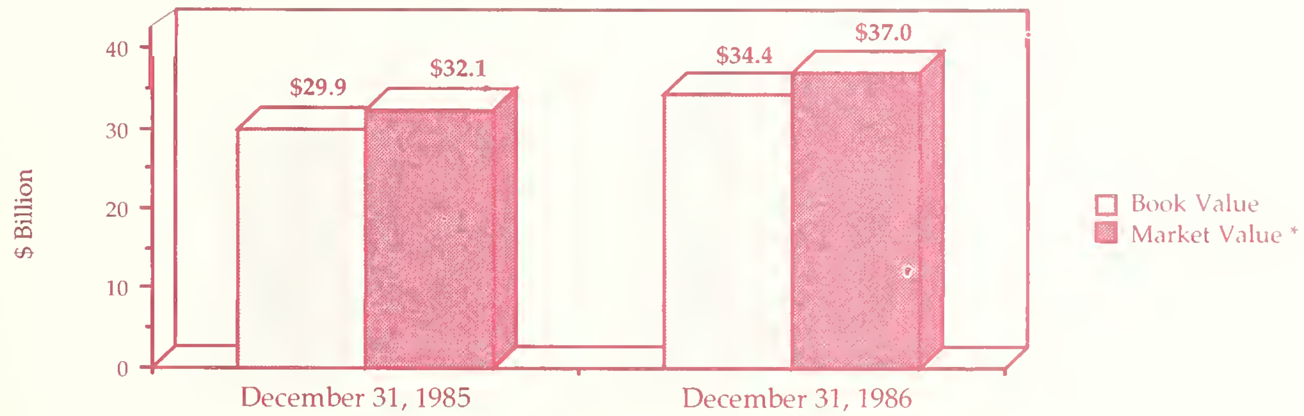
* Data as of December 31, 1985
** Same employers as TSF, PSSF, and Ryerson
*** Same members as TSF, PSSF, and Ryerson

FIGURE 1.3

Growth in Assets

Figure 1.4 shows the growth in assets, both market and book value, for Ontario's public sector pension funds from December 31, 1985 to December 31, 1986.

Ontario's Public Sector Pension Funds ~ Assets
December 31, 1986

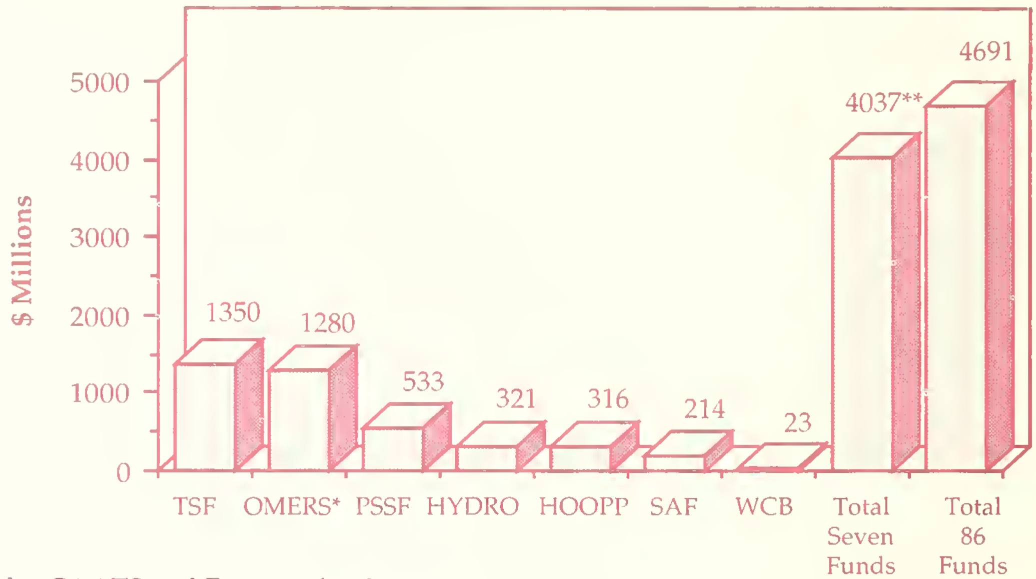


* Assets invested in non-market government debt are at book value.

FIGURE 1.4

During 1986, the market value of assets grew by over 15 per cent. Cash flow in 1986, represented by the change in the book value, amounted to $4.7 billion. Six funds accounted for 84 per cent ($4.0 billion) of the total cash flow. See Figure 1.5.

1986 Cash Flow of Seven Ontario Public Sector Pension Funds Compared With Total Cash Flow of 86 Funds



* Includes CAATS and Ryerson funds
** 86% of total cash flow

FIGURE 1.5

The 86 plans differ significantly in size as illustrated by Figure 1.6.

Ontario's Public Sector Pension Plans ~ Cumulative Distribution of Employees and Assets December 31, 1986

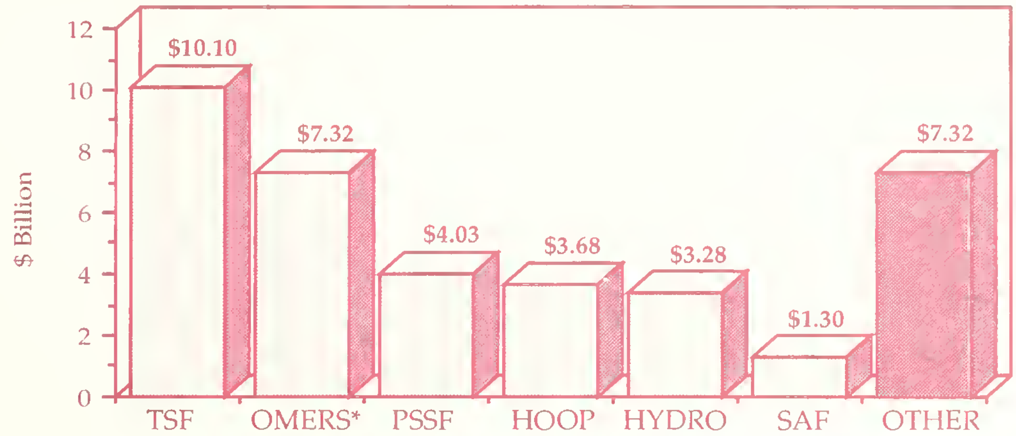
Cumulative No. of Plans	Cumulative No. of Employees (1985 Data)	Cumulative Percentage of Employees	Cumulative Assets ($ Billion)	Cumulative Percentage of Assets
6	445,384	84.2	29.72	80.2
10	478,082	90.4	32.42	87.5
20	499,027	94.4	35.06	94.7
50	526,722	99.6	36.98	99.8
86	528,763	100.0	37.04	100.0

FIGURE 1.6

Six plans account for 80.2 per cent of employees and 80.2 of assets while the smallest 36 plans account for less than 1 per cent of both employees and assets. Twenty plans have 94.4 per cent of employees and 94.7 per cent of assets.

Figure 1.7 compares the largest six funds in terms of assets.

Ontario's Public Sector Pension Funds
Assets of the Six Largest Funds ~ December 31, 1986



* Assets of the CAATS and Ryerson Funds are not included.

FIGURE 1.7

The TSF is the largest and has assets of $10.1 billion. The SAF is the smallest, with assets of $1.3 billion. OMERS, the second largest fund, is as large as 80 other funds combined.

These funds are among the largest in Canada, and are significant even in international terms. For example, the TSF would rank in the top 30 of the largest 1,000 United States pension funds. The other five funds would rank as follows: OMERS in the top 50, PSSF in the top 75, HOOPP in the top 80, HYDRO in the top 90 and the SAF in the top 200.[5] Quebec's Caisse de depot et placement would rank in the top 10.

Types of Pension Plans

Ontario's public sector pension plans fall into one of three categories: defined benefit related plan, defined contribution (or asset) related plan, or a combination of a defined benefit/asset related plan (combined).

Regardless of the type, most public sector pension plans are established under the provisions of the Pension Benefits Act, 1987 in the same way as private sector pension plans. Six of the largest pension plans, however, are established by specific statutes.[6]

Figure 1.8 shows the distribution of employees and assets of Ontario's public sector pension plans across these three types of pension plans.

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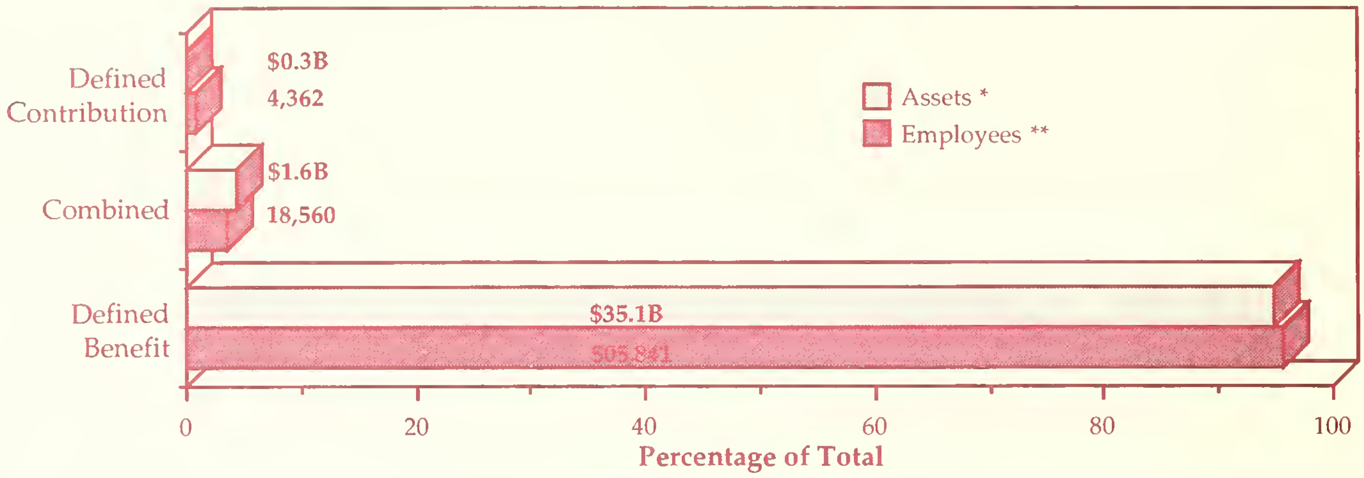
[5] See *Top 1000 Pension Funds/Sponsors*, Pensions & Investment Age, January 26, 1987, pp. 20-26 for ranking of funds as at September 30, 1986. Since data for Ontario's public sector funds is as at December 31, 1986, the rankings are approximate.

[6] The six statutes are: the Teachers' Superannuation Act (TSF), the Public Service Superannuation Act (PSSF), the Ontario Municipal Employees Retirement System Act (OMERS), the Superannuation Adjustment Benefits Act (SAF), the Workers' Compensation Act (WCB), and the Power Corporation Act (HYDRO).

Ontario's Public Sector Pension Plans ~ Employee and Asset by Type



* 1986 data for assets. Market value except for assets invested in non-market government debt which are at book value.

** 1985 data for employees

FIGURE 1.8

Forty-nine pension plans , with over 95 per cent of employees and slightly under 95 per cent of assets, are of the defined benefit type.

One plan, the SAF, is unique in that it is not a pension plan per se but provides supplementary inflation indexation to the beneficiaries of three public sector funds: the TSF, PSSF and Ryerson pension fund. For the purposes of this analysis, we have classified the SAF as a defined benefit type.

Eleven pension plans, with less than 4 per cent of employees and slightly more than 4 per cent of assets, are of the combined defined benefit/asset type. Universities sponsor most combined plans.

Twenty-six pension plans are of the defined contribution type, but they have less than one per cent of both employees and assets.

Almost half the defined benefit plans, and all except one of the combined plans, have assets of more than $100 million. The majority of the defined contribution plans have assets of less than $1 million.

Closed Plans

Twenty-one plans with 10,709 employees and $1.76 billion in assets are closed to new members (see Figure 1.9). All closed plans are either of the defined benefit or defined contribution type. Ten closed plans of the defined benefit type account for over 99 per cent of the employees and assets of the closed plans.

Ontario's Public Sector Pension Plans ~ Closed Plans by Sector as of December 31, 1986

Type	Municipalities	Education	Health	Total Plans	Total Membership*	Total Assets ($ Million)
Defined Benefit	9	–	1	10	10,648	1,755
Defined Contribution	5	3	3	11	61	5
TOTAL	14	3	4	21	10,709	1,760

* 1985 Data

FIGURE 1.9

Fourteen of the closed plans are in the municipal sector. These plans were originally set up for municipal employees and were eventually closed to new members after OMERS was established in 1962.

The balance of the closed plans are in the health and education sectors.

New employees of employers who have closed plans are now covered by OMERS or HOOPP.

In time, these 21 closed plans will terminate, having paid all benefits due to plan members and their beneficiaries.

SECTION III

Investments

This section looks at the investment of Ontario's public sector pension funds under the following headings (see Figure 1.10):

- Market and non-market investments
- Investment portfolio (asset mix)
- Internal vs. external management
- Investment performance

Investments of Ontario's Public Sector Pension Funds ~ 1986

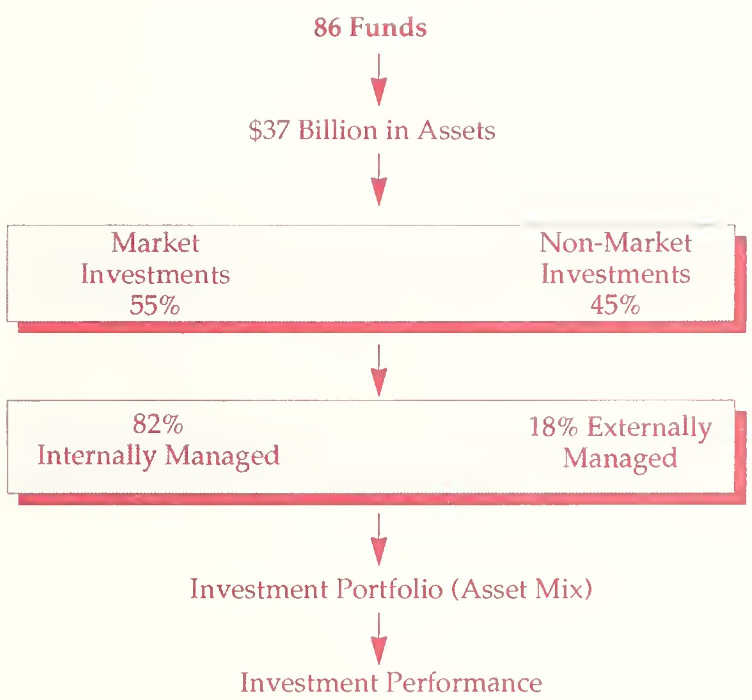


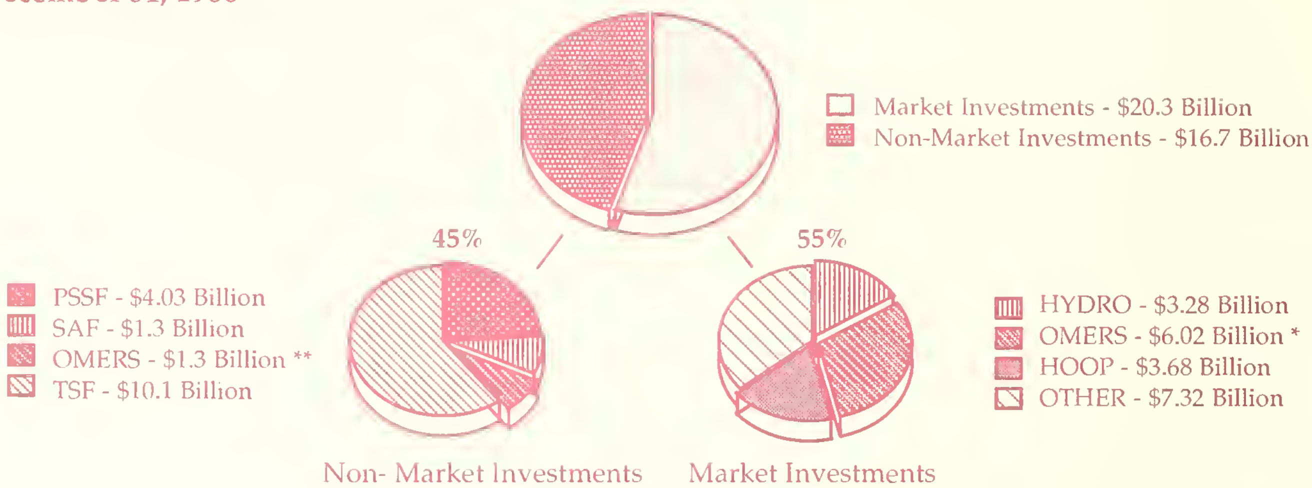
FIGURE 1.10

Market and Non-Market Investments

Fifty-five per cent of public sector pension fund assets are invested in market investments, while 45 per cent are invested in non-market government debt (see Figure 1.11).[7]

Ontario's Public Sector Pension Funds ~ Market and Non-Market Investments

December 31, 1986



* Excludes assets of the CAATS and Ryerson funds
** Some of OMERS non-market investments belong to the CAATS and Ryerson funds

Note: Total assets of all 86 funds are $37.0 billion.

FIGURE 1.11

Eighty-three public sector pension funds with assets of $20.3 billion have market investments. Three funds, the TSF, PSSF and SAF, invest in non-market government debt. One fund, OMERS, began to shift its investments from non-market to market investments in 1975, but about 16 per cent of the assets it manages, or $1.3 billion, are still invested in non-market government debt.[8]

Of the market investments, OMERS has 30 per cent, HOOPP has 18 per cent, HYDRO has 16 per cent, while 80 other funds have the remaining 36 per cent.

Of the non-market investments, the TSF has 60 per cent, the PSSF has 24 per cent and the SAF and OMERS have about 8 per cent each.

The assets of the TSF consist of non-market government debentures with maturity ranging from 20 to 25 years. The assets of the PSSF consist principally of 25 year deposits in the accounts of the Province. Assets of the SAF consist of 1 to 20 year deposits in the accounts of the Province.

The Province of Ontario borrows for its own purposes and also on behalf of Ontario Hydro and certain other government-related organizations. Figure 1.12 shows that

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[7] Of the other jurisdictions in Canada, only Quebec, British Columbia and the Federal Government invest public sector pension assets in non-market government debt – See *Description of Pension Fund Arrangements in Other Jurisdictions*, Background Paper #3 (unpublished), (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987).

[8] Some of the OMERS non-market government debt belong to CAATS and Ryerson.

of the debt accumulated for the Province's own purposes, almost half is owed to four public sector pension funds – the TSF, PSSF, OMERS and SAF. A further 42 per cent is owed to the CPP Investment Fund.

If borrowings on behalf of Ontario Hydro and others are included in the calculations, market investments become more prominent. The total of the Province's debt for its own purposes and for Ontario Hydro and others includes 27 per cent from the four Ontario pension funds mentioned above and 25 per cent from the CPP Investment Fund.

Composition of Ontario's Own-Purpose Debt*
March 31, 1987

Own-Purpose Debt	Amount ($ Billion)	Percent
Funded Debt**		
PUBLIC	1.521	4.3
NON-PUBLIC:		
CPP	14.727	42.0
TSF	10.029	28.6
OMERS	1.293	3.7
OTHERS	0.351	1.0
Total	27.921	79.6
Debt Financed through Non-Budgetary Transactions		
PSSF	4.563	13.0
SAF	1.514	4.3
OTHER	1.105	3.1
Total	7.182	20.4
Total Own-Purpose Debt	**35.103**	**100.0**

* The Province also has borrowed or has guaranteed on behalf of Ontario Hydro a total of $24.3 billion of which $1.1 billion is from the CPP. Total debt owed to the CPP Investment Fund therefore is $15.8 billion. The Province also has guaranteed debt of $4.5 billion for local governments, provincial agencies, universities and hospitals.

** Funded debt involves a bond or similar debt instrument.

FIGURE 1.12

Investment Portfolio (Asset Mix)

Figure 1.13 shows the distribution of the assets of 41 funds which hold 94 per cent ($19.1 billion) of the assets invested in market investments and for which the Task Force was able to obtain information.[9]

[9] The assets have been distributed based on asset mix information as at December 31, 1985. We have assumed that asset mix at December 31, 1986 is similar to the asset mix as at December 31, 1985.

Ontario's Public Sector Pension Funds ~ Distribution of Market Investments

December 31, 1986 ($Billion)

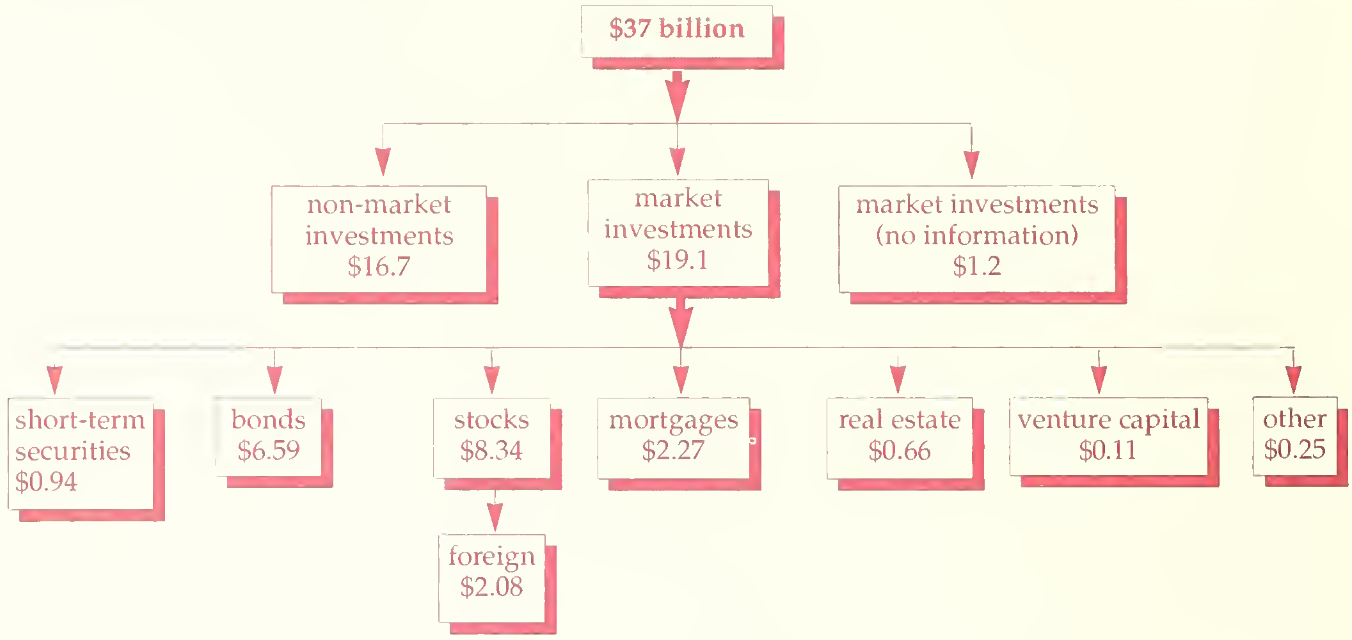


FIGURE 1.13

Stocks and bonds comprise the principal investments of these pension funds, followed by mortgages and short-term securities,[10] real estate, and venture capital. Of the stocks, one-quarter of the value is in foreign stocks.

Figure 1.14 reveals that while virtually all funds analyzed invest in bonds and in Canadian stocks, not all funds invest in foreign stocks and still fewer funds invest in mortgages and real estate. Only five funds make venture capital investments.

Ontario's Public Sector Pension Funds by Investment Classes

December 31, 1985

Investment Class	No. of Funds	Average Investment (as percent of assets of fund)	Investment Range for Two-Thirds of Funds (as percent of assets of funds)
Short-Term Securities	41	8.3	0.1 - 18.1
Stocks			
- Canadian	41	35.2	26.2 - 44.2
- Foreign	36	9.4	5.6 - 13.1
Bonds	41	41.1	26.5 - 55.7
Mortgages	27	6.9	0.1 - 13.9
Real Estate	12	3.9	0.8 - 7.0
Venture Capital	5	0.9	0.6 - 1.1

FIGURE 1.14

[10] Short-term securities represent short-term deposits which are readily converted to cash.

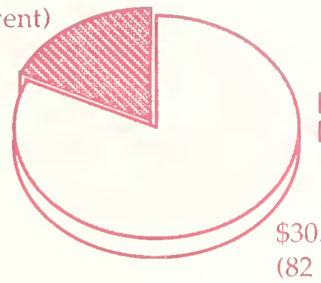
Figure 1.14 also shows a substantial variation in asset mix among funds which invest in the same classes. These differences in investment policies appear to explain the variations in performance (discussed below).

In general, the larger the fund the more likely it is to make non-traditional investments, such as mortgages, real estate and venture capital.

Internal vs. External Management

As shown in Figure 1.15, ten funds with 82 per cent of the assets ($30.5 billion) manage their investments internally.[11] The remaining seventy-six funds, with 18 per cent of the assets ($6.5 billion), use external investment managers.[12]

Ontario's Public Sector Pension Funds ~ Internal vs. External Management
December 31, 1986



Note: Total assets of all 86 funds are $37.0 billion.

FIGURE 1.15

Some general observations:

- The six funds with assets over $1 billion are internally managed. Three of these, the TSF, PSSF and SAF, are invested in non-market government debt and so have very limited investment management.
- All ten internally managed funds are defined benefit related plans.
- No fund with less than $160 million in assets is internally managed.
- None of the over 20 university pension funds is internally managed, although nine university funds have assets over $160 million.
- The availability of internal expertise does not appear to determine whether a fund is internally managed. Employers who sponsor the four internally-managed funds with assets under $1 billion have large treasury and finance departments. Similar expertise is available in four non-university funds

[11] The ten internally managed funds are: TSF, PSSF, SAF, OMERS, HOOPP, HYDRO, Toronto Civic Employees, Toronto Fire Department, Ontario Northland Transportation, City of Ottawa. The assets of CAATS and the Ryerson pension fund which are managed by OMERS are counted as externally managed and are not included in the total assets for OMERS.

[12] Some funds did not provide information on type of management. Given other information about these funds, the Task Force determined that all are externally managed.

with assets over $160 million and less than $1 billion, but they are managed externally.

A small portion of the assets held by OMERS and HOOPP is managed externally. OMERS itself is the investment manager and plan administrator for the pension plan of the 22 Colleges of Applied Arts and Technology (CAATS) and for the Ryerson pension plan.

As a general rule, the assets of externally managed defined benefit and combined type plans are invested through professional investment managers, while the assets of defined contribution plans are managed by life insurance companies and are often invested in term deposits or in pooled arrangements which may or may not hold a diversified portfolio.

Investment Performance [13]

Direct performance comparison among public sector pension funds or between public and private sector pension funds may not be very useful or fair for many reasons, including:

- Differences in investment objectives
- Differences in investment risk tolerances
- Lack of a common numerical base, in many cases
- Lack of sufficient data, in certain cases.

However, certain general observations are possible.

With respect to investment performance, Ontario's public sector pension funds can be categorized as follows:

- those funds which invest their assets in non-market government debt.
- those funds which invest their assets in interest-bearing deposits or fixed return instruments, with life insurance and trust companies.
- those funds whose assets are pooled with others and are invested in diversified instruments.
- those funds whose assets are not pooled, are invested in diversified market instruments and are managed internally or externally by professional pension fund organizations.

The three funds whose assets are invested solely in non-market Ontario debt – the TSF, PSSF and SAF – earn a return that is related to the yield on outstanding market debentures of the Province or guaranteed by the Province. Consequently, performance is directly related to changes in market interest rates.

The performance of funds which invest in interest bearing deposits or other fixed income investments, mostly defined contribution type funds, also relates to changing market interest rates. The assets are usually invested in either five-year deposits or placed in pools which may hold only fixed income securities.

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[13] For a detailed discussion of performance issues, see Appendix D, *Capital Market Returns, Public Sector Pension Funds and Asset Mix Policy'* by Keith Ambachtsheer.

Most defined benefit and combined pension funds and a few defined contribution funds have diversified investment portfolios. The performance of these funds naturally reflects the market performance of the particular asset mix held by each fund.

Figure 1.16 compares the rate of return performance[14] of 21 diversified Ontario public sector pension funds with each other and with other Canadian pension funds.[15]

Comparison of Investment Performance: 1981-1985

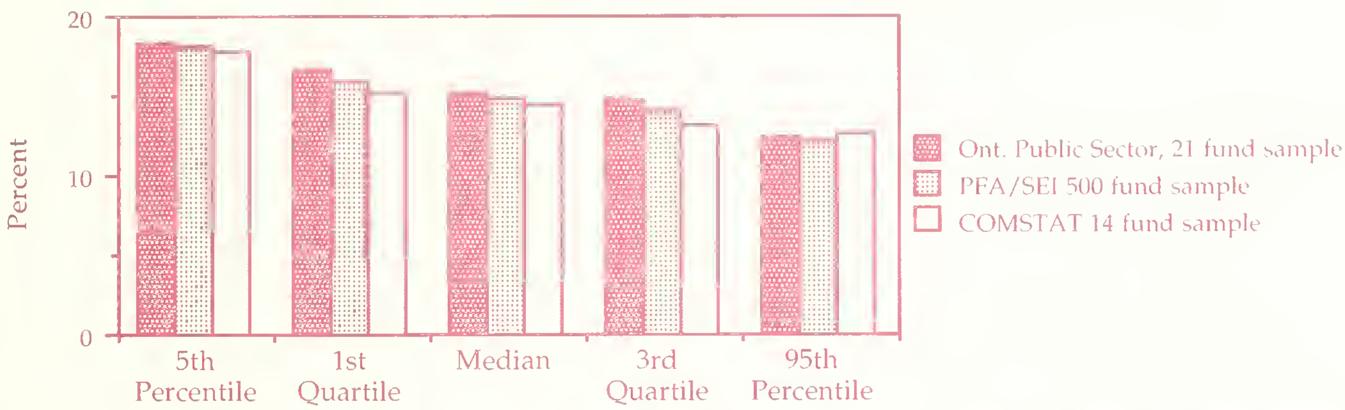

FIGURE 1.16

Three key observations:

- There has been a substantial variation in performance among Ontario's public sector pension funds with diversified investments. Annual rates of return ranged from 18.4 to 12.4 per cent for the period 1981-1985.
- Ontario's public sector pension funds have performed as well as, if not better than, other Canadian pension funds,[16] as reported by Pension Finance Associates (PFA).[17]
- Ontario's public sector pension funds which invest in market investments through pooled arrangements have, as measured by COMSTAT,[18] marginally

[14] Performance comparison is shown in the form of percentiles and quartile breaks. Funds are ranked in order of highest to lowest performance and groupings are based on the top 5 per cent of funds (5th percentile), the top one-quarter of funds (lst quartile), and the top three-quarters of funds (3rd quartile). For example, a return break of 18 per cent for the 5th percentile means that 5 per cent of the funds in the sample achieved at least a return of 18 per cent. Or a return break of 14 per cent for the 3rd quartile means that three quarters of the funds achieved a return of at least 14 per cent. The median return break falls in the middle of the sample i.e. half the funds achieved a higher return and the other half a lower return.

[15] The 21 Ontario public sector pension funds for which comparable rate of return information is available have combined assets of over $20 billion.

[16] Similarities in rate of return performance are explained by similarities in asset mix. See Appendix D, *Capital Market Returns, Public Sector Pension Funds, and Asset Mix Policy.*

[17] The PFA (now SEI) sample consists of 500 Canadian diversified funds which subscribe to the firm's performance measurement service.

[18] The COMSTAT Pension Management Centre (COMSTAT) sample consists of 14 Canadian diversified pooled funds.

underperformed both segregated public sector pension funds and pension funds generally.[19]

Figure 1.17 illustrates the investment performance of the 21 public sector pension funds for which comparable data was available, in relation to the relative sizes of the funds and whether they use internal or external investment managers.

Comparison of the Investment Performance of 21 Ontario Public Sector Pension Funds: 1981-1985

Ranked by Increasing Asset Size

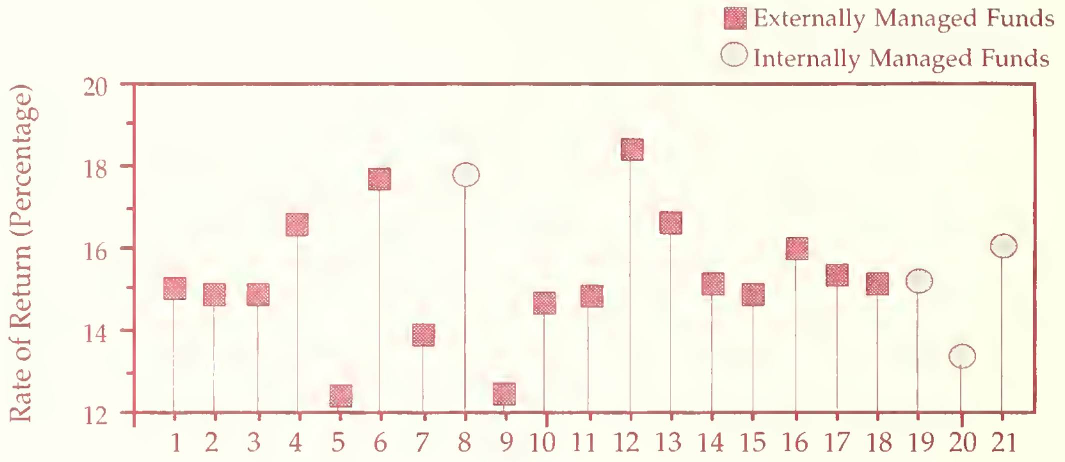

FIGURE 1.17

Relative size of the pension funds does not appear to be a factor in explaining the performance variation among Ontario's public sector funds for the five-year period ending in 1985.

Because of the limited number of observations available, no definite conclusion can be drawn with respect to relative performance among internally managed and externally managed funds. It would appear, however, that the performance of internally managed and externally managed funds has been indistinguishable in the five-year period ending in 1985.

As noted in Figure 1.14, not all funds are invested in all investment classes and there is substantial variation in asset mix even among the funds which invest in the same investment classes.

Figure 1.18 compares rates of return for different investment classes over 5, 10 and 25 year periods ending in 1985.[20]

[19] We assume the performance of the COMSTAT 14 pooled diversified sample to be a proxy for the performance of those public sector funds whose assets are invested through diversified pooled arrangements.

[20] There are different levels of risk associated with different investment classes. The rates of return depicted in Figures 1.16, 1.17 and 1.18 are not risk-adjusted.

Comparison of Investment Performance by Type of Asset: 1960-1985

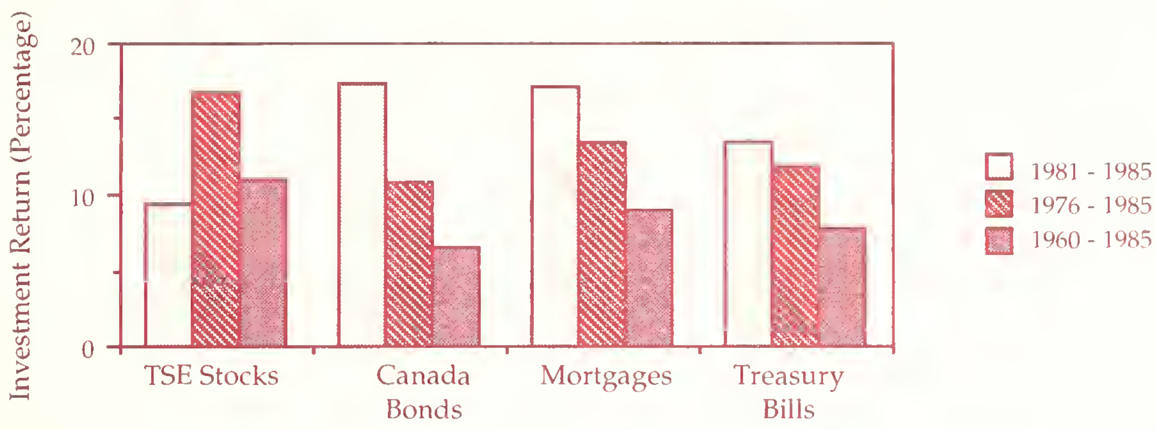

FIGURE 1.18

Two key observations are:

- There is a sizeable variation of rates of return for different investment instruments. This implies that the investment performance of any pension fund would very much depend on the kind of investment policy the fund had in place. A pension fund which follows a policy of being heavy on stocks and light on bonds would have, in all likelihood, performed better than another fund with the reverse investment policy over the last 10 or 25 years.
- Experience in the five-year period to the end of 1985 is not typical of the relative performance of the various types of investment instruments over longer time horizons. Bonds, mortgages and Treasury Bills have performed better than stocks[21] during this five-year period despite the fact that these investment instruments are considered less risky than stocks.[22]

Whatever period one chooses to consider, it appears that asset mix is the most important factor in the relative performance of pension funds over time.

SECTION IV

Practices and Policies

This section briefly discusses some of the practices and policies of Ontario's public sector pension plans. Areas covered include collective bargaining, surpluses, funding policies and inflation protection.

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[21] United States stocks, as measured by the S&P 500, have performed substantially better than Canadian stocks, as measured by the TSE 300 during the 1981-1985 period.

[22] In theory, the riskier the investment, the higher the expected return over the long term. Risk, as measured by the variability in returns, has been highest in stocks, followed by bonds, mortgages and treasury bills in all periods - 5, 10 and 25 years.

Collective Bargaining

Collective bargaining for pension benefits is prohibited for some public employers by the Crown Employees Collective Bargaining Act. While collective bargaining is legally allowed in the health sector, it is not in fact used for pensions for plan members of HOOPP because of structural difficulties. It is estimated that only about 10 per cent of the 530,000 public sector pension plan members bargain collectively for pension benefits. However, at least another 41 per cent of the members belong to plans where there are formal discussions between employers and employee representatives on benefits and other pension matters. See Figure 1.19.

Collective Bargaining for Public Sector Pensions ~ 1985
Percentage of Active Plan Members

FIGURE 1.19

Surpluses

In defined benefit and combined pension plans, surpluses or deficits can arise when experience differs from actuarial assumptions.

Forty funds provided the Task Force with information on their latest actuarial valuations. All 40 reported a surplus with the combined surplus amounting to about $2.5 billion.

Plan policies on who benefits from a surplus vary. Thirty plans use surpluses to improve benefits. Eight plans use surpluses both to improve benefits and to reduce employer contributions. In at least two of these eight plans, employee contributions may also be reduced. These plans are of the combined defined benefit/asset related type. In only two plans are surpluses used solely to reduce employer contributions.

Funding Policies

Both the employer and employee contribute to the pension fund in all but one small plan.

Most plan members contribute between 7 and 8 per cent of salary. A very small portion (about eight per cent of all plan members) contribute less than five per cent.

Compared to the private sector, Ontario's public sector employees contribute a higher percentage of their salaries towards the cost of their pensions.[23] Indeed, the majority of private sector plan members do not contribute to the cost of pensions; only the employer contributes.

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[23] *A Comparison of Private and Public Sector Pension Plans*, Research Report #3, p. 56.

Inflation Indexing

The vast majority (98 per cent) of Ontario's public sector employees belong to plans which to some extent, whether automatically or in ad hoc fashion, adjust benefits for inflation. Included in this number are the contributors to the PSSF, TSF and Ryerson plans which have their benefits fully inflation-indexed through the SAF. Most of the other plans which provide adjustments are not fully indexed. See Figure 1.20.

Ontario's 530,000 Active Public Sector Pension Plan Members
Pension Inflation Indexing ~ December 31, 1985

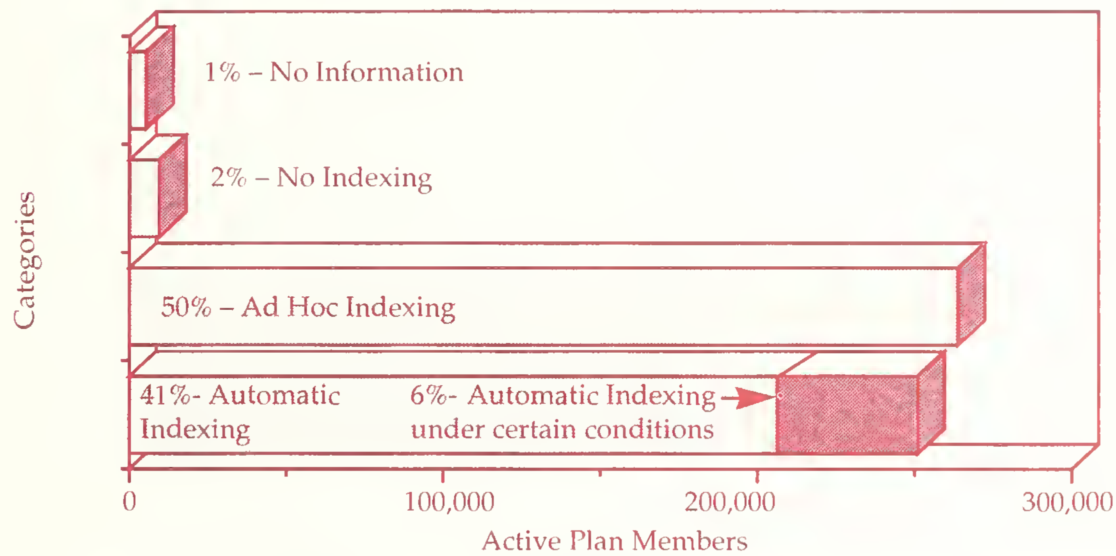

FIGURE 1.20

SUMMARY

This chapter presents an overview of Ontario's public sector pension plans and funds:

- Eighty-six public sector pension plans have pension funds. In a further 13 plans with a total of 155 employees, there is no accumulation of assets; instead retirement benefits are purchased regularly. These plans are therefore not considered further in our report.
- The 86 plans represent about 2,000 employers and 530,000 employees and hold $37 billion in market value assets.
- Some plans are extremely large with over 100,000 employees and some are extremely small with less than 10 employees.
- In terms of number of plans, employees covered and assets, defined benefit plans dominate. Almost all of the smaller plans are of the defined contribution type.
- There is a high degree of centralization. Of the 2,000 public sector employers, about 1,800 are represented in 10 plans which have about 484,000 employees or 93 per cent of all public sector employees.
- There is a variety of investment practices.

- Three funds, the TSF, PSSF and SAF, invest all their assets in non-market Ontario government debt. OMERS also has about 16 per cent of its assets in non-market Ontario government debt.

- Ten funds with 82 per cent of all assets are internally managed. Seventy-six funds with the remaining 18 per cent of assets are managed by professional pension fund managers, insurance and trust companies.

- Public sector pension funds which invest in market investments have performed as well as, if not better than, private sector pension funds. This reflects similar investment policies.

- There has been substantial variation in investment performance among public sector pension funds. Investment policies, particularly asset mix, rather than size or management structure (i.e. internal vs. external management) appear to be the cause.

- All public sector pension funds which provided information on their most recent actuarial valuations reported an actuarial surplus, the total of which amounted to about $2.5 billion.

- Most public sector employees contribute between 7 and 8 per cent of salary. The vast majority of public sector employees belong to plans which provide inflation adjustments to pensions. Only about 10 per cent bargain collectively for pension benefits.

CHAPTER 2

ISSUES

SYNOPSIS

Nine key issues arise from our terms of reference and from briefs and other sources. Briefs to the Task Force reflect disagreement on the rights of employers and employees to use surpluses and control investment decisions. However, there is widespread agreement that public sector plans should follow the same rules as private sector pension plans and that public sector pension funds should not be further centralized.

Introduction

This chapter outlines the nine key issues and summarizes comments relating to these issues contained in briefs submitted to the Task Force.

Terms of Reference

On establishing the Task Force, Premier Peterson stated:

"It is important that we ensure that the investment of public sector pension plans best serve pension beneficiaries, meet the circumstances of today's financial environment and advance the province's economic development."

Accordingly, our terms of reference require us to assess whether the current methods and approaches to the investment of public sector pension funds in Ontario satisfy the objectives cited by the Premier.

Briefs

The Task Force advertised widely and contacted a large number of organizations to invite briefs. As a guideline to organizations preparing briefs, we provided a list of issues of particular interest to us in view of our terms of reference.

We received 64 briefs from individuals and organizations. In one way or another, most of the views expressed relate to the nature and purpose of a pension plan.

Briefs came from five main sources:

- Employers/employer groups
- Employee groups (unions and professional associations)
- Employees/pensioners

- Pension plan advisors/professional groups
- The financial community.

The views expressed by these groups, including their views on matters which are outside our terms of reference, are set out in an unpublished Background Paper.[1] Their views on the key issues identified by the Task Force are summarized below.

We also benefited greatly from a seminar held at the Niagara Institute, June 15 to 17, 1987.[2]

Issues

Based on our analysis, we identified nine key issues.

These issues – and the comments made in the briefs submitted – are summarized below. The issues are analyzed in Chapters 3, 4, and 5, and are discussed in later chapters in relation to specific pension funds.

ISSUE 1: The Pension Deal

The pension deal is the statement of the pension promise by an employer and the means by which that promise will be fulfilled. This issue is fundamental to an understanding of pension fund investment. It includes such questions as:

- Which type of pension deal is in effect? Is it clearly understood by all parties? Are current practices well aligned with the deal?
- How is the pension deal established? Is there a clear and legitimate process for changing the deal?

Comments in the briefs about the pension deal

Only the Ontario Federation of Labour (OFL) and the Ontario Teachers' Federation (OTF) have expressed views on how the pension deal should be established or changed.

The OFL argues for collective bargaining of pensions, including plan design, plan administration, asset management, responsibility for deficits, representation of employees, investment practices, accountability and utilization of surpluses.[3]

The OTF is generally satisfied with the present formal review process for changing the teachers' pension deal (that process appears similar in many respects to collective bargaining), and with the absence of any link between pensions and salary negotiations.

Generally, all briefs agree that the essential purpose of a pension plan is to provide retirement benefits to plan members and their beneficiaries and to create a mechanism which ensures that those benefits will be paid when the time comes.

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[1] A *Summary of Briefs Submitted to the Task Force,* Background Paper #2 (unpublished), (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987).

[2] The seminar program and list of participants are provided in Appendix F.

[3] Ontario Federation of Labour (OFL) Brief to the Ontario Task Force on the Investment of Public Sector Pension Funds, March 2, 1987.

ISSUE 2: Ownership of a Pension Fund Surplus (Deficit)

This issue deals with the question of who owns (i.e. who benefits from or bears the burden of) any surplus or deficit in a pension fund. Subsidiary questions include:

- What has been promised to plan members in the pension deal? Have they received it?
- Who has the liability to fund what has been promised to plan members?
- What is a pension fund surplus (deficit)? Is it real?
- Should a surplus be treated differently than a deficit?

Comments in the briefs about pension fund surplus (deficit)

This issue produced the greatest diversity of opinion.

Employers/employer groups state that, in a defined benefit plan, the employer bears the burden of poor investment performance and should have the benefit of good investment performance. In many cases, employers share good investment performance with plan members through ad hoc inflation adjustments or improved benefits for current and retired employees.

Employee groups state that pensions (and pension contributions) represent deferred compensation and that plan members own the pension fund and any surplus which arises.

As well, some employee groups state that employers who assume that they bear all of the burden of a deficit in a defined benefit plan are wrong because, in a total compensation context, it is the employee who pays the cost of a deficit when salaries are next negotiated.

ISSUE 3: Pension Fund Control

This issue deals with the question of who controls the pension fund (i.e. who determines the pension fund structure, appoints the pension fund governors and determines their investment powers). A subsidiary question is:

- If one party (e.g. the plan sponsor/employer) controls the pension fund, what role does the other party have?

Comments in the briefs about pension fund control

This issue also produced a diversity of opinion.

Employers/employer groups state that, in a defined benefit plan, the employer bears the burden of poor investment performance and should therefore control the pension fund.

Employers/employer groups express varying views on employee involvement, some opposing it and others having introduced it. Pension plan advisors generally support some degree of employee involvement.

Employee groups state that plan members should control investment decision-making since "after all it is their money," and since employees end up paying for any

deficit in the pension fund through later total compensation settlements. Some employee groups state that, at the very least, employees should share control with the plan sponsor/employer.

ISSUE 4: Investment Policy

This issue deals with the establishment and implementation of investment policy. It involves such questions as:

- Should public sector pension funds follow the same rules for investments as private sector pension funds, or different rules?
- Is it appropriate for some public sector pension funds to be invested in non-market government debt?
- What is the meaning of prudency in light of the prudent person test contained in the Pension Benefits Act, 1987? How can those responsible for pension fund investments ensure that this test is met?
- What responsibility do pension fund fiduciaries have with respect to governance of corporations in which a pension fund has invested (e.g. South African investments)?
- Should pension fund investments, once made, be managed passively or actively? Do pension fund investment managers have corporate responsibilities and, if so, how should these be exercised?
- Can public sector pension funds be invested in ways which enhance the provincial or national economy? Is this happening now? Should it be encouraged?
- Should public sector pension funds adopt social/ethical criteria for investment? If so, should such investments be limited to situations with neutral or positive effect on the rate of return?

Comments in the briefs about investment policy

Investment policy is at the heart of most briefs.

With few exceptions, there is a consensus that public sector pension funds should be governed by the same rules as private sector pension funds.

Most of those submitting briefs argue that the current practice of investing the PSSF and the TSF in non-market government debt is not appropriate. Teachers, employer groups and most pension plan advisors advocate investing through the capital market. There is considerable support for the view that this approach will lead to greater efficiency in the use of capital in the economy, and hence contribute to economic enhancement.

The OFL proposes that 10 per cent of the PSSF be invested in the capital market in order to establish a market rate of return for the fund as a whole but have no objection to all of it being invested in the capital market.

Many are concerned that continued investment in non-marketable securities at a time when society is aging will put their pensions in jeopardy, since there are no capital assets directly backing the pension promise. As a result, plan members will be dependent on the good will of future taxpayers to pay for the pension benefits

promised today. Investment in the capital market is considered a safer option, in the view of many who submitted briefs.

Those who discuss prudency appear to equate it with achieving a high rate of return on assets with an acceptable level of risk. The need to diversify types of investments in order to minimize risk also is stressed.

Several briefs comment on the desirability of removing constraints on investment flexibility. They support the prudent person test introduced in the Pension Benefits Act, 1987, as a more flexible guide, and advocate relaxing the limitation on investments outside Canada.

The general view in the briefs is that the Government should achieve its social objectives through means other than directing pension fund investment. However, several briefs suggest that social or economic benefits can be (or even should be) obtained as side-effects of public sector pension fund investments, as long as the rate of return objective is primary. Other briefs note that pension funds contribute to economic enhancement when invested through the capital markets.

The OFL position is that a lower rate of return, resulting from social and ethical investments, could be acceptable provided the social values on which investment decisions are based are those of employees.

ISSUE 5: Accountability

This issue has a number of dimensions, including:

- For what and to whom are pension fund governors accountable? How do they demonstrate that they have acted in the best interests of those to whom they owe a fiduciary duty? If pension fund governors are appointed by one group (employees or employers), how is their fiduciary duty affected?
- What should pension fund governors report on? And to whom? Can and should a common reporting format for public sector pension funds be developed?
- How is the taxpayer's interest protected? Are public sector pension fund governors accountable to the taxpayer, and if so, how?
- How are plan members' interests protected? How are the interests of those entitled to deferred pensions protected?

Comments in the briefs about accountability

Few briefs address the issue of accountability directly. None of the briefs discuss the kind of information that pension fund governors should provide to plan members or to other interested persons.

Briefs of employee groups suggest that pension fund governors would be accountable if their membership was representative. Some briefs advocate 50 per cent representation for plan members as a minimum.

There is an assumption on the part of many employers with defined benefit plans that accountability is mainly to the employer and the Pension Commission of Ontario and that accountability to plan members is of lesser importance.

ISSUE 6: Roles of the Government

This issue arises because the Government has many roles in connection with public sector pension plans: legislator/regulator, plan sponsor, employer, contributor, guarantor of others' pension promises, source of funding for others' pension promises and guarantor of others' debt. The issue raises many questions including:

- Are the various roles of the Government clearly understood by all and is each role exercised properly?
- Does the Government carry out its plan sponsor/employer role effectively?
- To what extent is it necessary for the Government to ratify benefit changes when these have been negotiated by collective bargaining and the Government is not the plan sponsor or the employer?

Comments in the briefs about roles of government

While, there were no explicit comments in the briefs on this issue, discussions with interested parties have prompted the Task Force to consider the issue.

ISSUE 7: Investment Management Structure

This issue relates to the most appropriate investment management structures for public sector pension funds. The questions involved include:

- Could centralized investment of public sector pension funds result in more effective investment and in economic enhancement for the province?
- Are there disadvantages of centralized investment which outweigh the potential benefits?
- What are the relative advantages of internal versus external investment management?

Comments in the briefs about investment management structure

Very few briefs support more centralization of pension fund investment than currently exists in Ontario. The common view is that whatever benefits might arise from greater centralization would be more than offset by the risk of undue government intervention and influence, decreased flexibility both in investments and in plan administration and adverse effects on the capital markets.

A few briefs suggest that there may be a case for amalgamating some small funds or at least offering them the option to join a large fund in order to gain economies of scale and the opportunity for more diversified investment opportunities.

ISSUE 8: Investment of Canada Pension Plan (CPP) Funds

This issue arises directly from our terms of reference and involves such questions as:

- Should Ontario borrow from the national CPP Investment Fund whether or not these monies are needed to meet its borrowing requirements?
- If CPP monies are borrowed, what investment criteria should be used? Should these investment criteria be the same or different from those of public sector pension funds?

Comments in the briefs about the investment of Canada Pension Plan funds

Some employee groups believe that CPP funds should be invested by the Government in infrastructure investments rather than being used for normal operating costs of government.

Some pension plan advisors recommend that CPP funds not be invested in the capital market but be used to redeem higher cost provincial debt.

Of those who comment on this issue, there is an almost unanimous view that the investment management of CPP funds should not be centralized with other public sector pension funds.

ISSUE 9: The Taxpayer's Interest

This issue concerns the interest of the taxpayer in public sector pension funds. The questions involved include:

- What is the nature of the taxpayers' interest?
- Is that interest well represented?
- How would the taxpayer approach public sector pension fund issues?
- Is the taxpayer being asked to assume too much risk?

Comments in the briefs about the taxpayer's interest

While there were no comments in the briefs on this issue, we believe, based on our discussions, that it is important.

CHAPTER 3

THE PENSION DEAL

SYNOPSIS

Five kinds of pension deals are in use in the public sector. Most major public sector pension deals are nominally defined benefit related deals. Each type of pension deal has implications for who determines pension fund structure. There are divergent views about who owns a surplus in defined benefit related deals. We consider any surplus or deficit to have two parts. Better methods for changing many public sector pension deals are needed.

Introduction

The pension deal is the statement of the pension promise by an employer to an employee and the means by which that promise will be fulfilled.

This chapter reviews the basic components of any pension deal and describes six types of pension deals, five of which are in use in the public sector. It sets the stage for an analysis, in Chapters 6 to 13, of the seven public sector pension funds included in our terms of reference. It also introduces the discussion of pension fund structure and investment policy in Chapters 4 and 5.

The chapter is divided into nine sections:

I. **Components of the pension deal**

II. **How the pension deal is set out**

III. **Kinds of pension deals**

IV. **Public sector pension deals**

V. **Roles of government**

VI. **Taxpayer's stake**

VII. **Pension entitlement as part of total compensation**

VIII. **Ownership of a surplus (deficit)**

IX. **Changing the pension deal.**

SECTION I

Components of the Pension Deal

There are eight main components of any pension deal. These components, which are shown in Figure 3.1, are:

- **Membership Criteria:** Which employees participate in the pension plan?
- **Benefits Policy:** What pension benefits does the plan provide?
- **Funding Policy:** Who contributes to the pension fund, when and how much?
- **Ownership of Surplus (Deficit):** Who benefits from a surplus and bears the burden of a deficit in the pension fund?
- **Pension Fund Structure:** Who determines the pension fund structure and appoints the pension fund governors? How should the governors operate? How and to whom are they accountable?
- **Investment Policy:** Who sets the investment policy for the pension fund? What is it and how is it implemented?
- **Plan Administration:** Who appoints the pension plan administrators? How should they operate? How and to whom are they accountable?
- **Changing the Pension Deal:** How are changes made to the pension deal?

The Eight Components of a Pension Deal

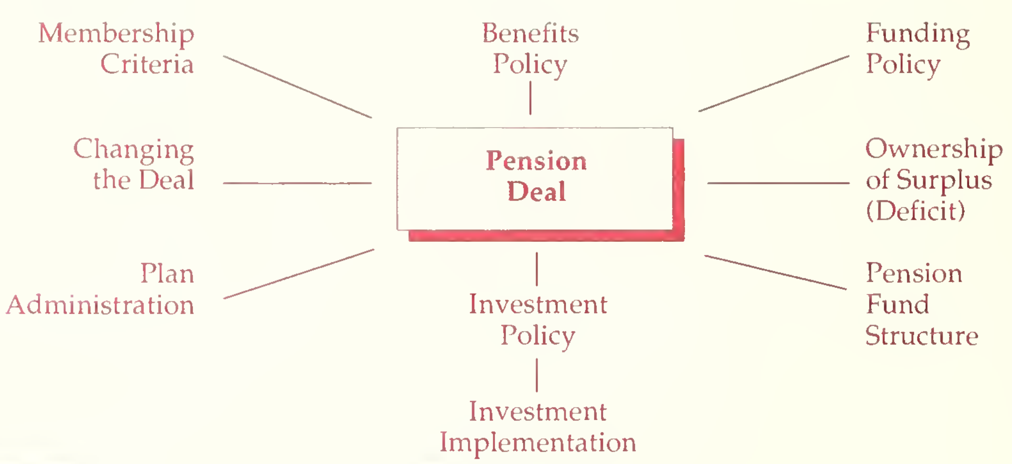

FIGURE 3.1

SECTION II

How the Pension Deal is Set Out

The formal pension deal is normally set out in:

- the pension plan documentation (i.e. the plan text)

- the pension fund documentation (i.e. the trust agreement, investment management agreement or investment advisory agreement)
- a collective bargaining agreement (if applicable).

The plan documentation and the fund documentation are the legal foundation of the formal pension deal. In union situations, they are usually preceded by a collective bargaining agreement or a pension agreement which outlines the basic elements of the pension deal to be included in the plan documentation. In the case of several major public sector pension plans, the formal pension deal is set out in legislation.

Current practice is often not consistent with the formal pension deal for three reasons:

- First, lack of clarity in the pension documentation can result in conflicting views about the pension deal, particularly as it relates to who "owns" a surplus (deficit).
- Second, an employer's record of ad hoc inflation adjustments may give rise to implicit employee expectations that similar updates will be provided in the future.
- Third, the formal deal may effectively be changed by informal means, such as the way the plan is administered and interpreted by plan administrators, and by employee communications to plan members.

Information provided to plan members usually consists of an employee booklet describing the pension plan, and informal briefings, newsletters and similar materials or activities. Poor communications can undermine the most carefully drafted plan documentation and can change the pension deal. For example, a mis-statement by the plan administrator or a personnel department employee concerning the plan may bind the employer to act in accordance with the mis-statement.

SECTION III

Kinds of Pension Deals

Pension deals can be grouped into three general categories:

- defined benefit related: where the promise is an agreed-upon pension at retirement
- asset related: where the promise is an agreed-upon contribution rate until retirement
- combined defined benefit/asset related: where the promise is a combination of the two.

The decision to establish a pension plan and the choice of a particular pension deal reflect many things, such as the employer's willingness and ability to provide a pension, the marketplace in which the employer operates, the legal and regulatory environment, social norms and any bargaining that may have taken place between the employer and his employees.

This section describes the general characteristics of six kinds of pension deals: two defined benefit related, two combined defined benefit/asset related and two asset related. While public sector pension deals do not all neatly match these kinds of pension deals, this classification is nevertheless a useful starting point for our review and assessment of public sector pension deals and their investment implications.

Figure 3.2 illustrates these six kinds of pension deals.[1]

Six Kinds of Pension Deals

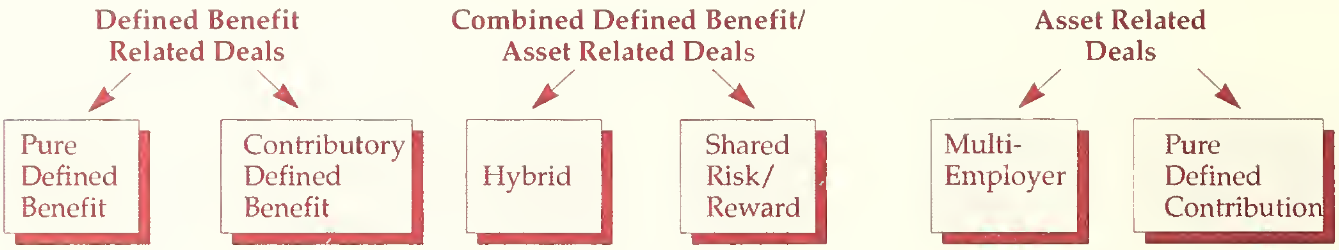

FIGURE 3.2

Defined Benefit Related Pension Deals

Pure defined benefit deal – the employee is promised a pension benefit normally determined by a formula based on a combination of salary or a stipulated amount and years of service.

The employer alone contributes towards the cost of the pension benefit. The employee makes no direct contribution.

Normally, the interest of plan members in the pension fund is limited to ensuring that the employer's funding policy and the pension fund itself are and will be adequate to provide the pension benefits promised. Consequently, the employer alone benefits from a surplus (e.g. through a withdrawal of surplus or decreased future contributions) and bears the burden of a deficit (through increased contributions) in the pension fund.

Decisions relating to pension fund structure and investment policy are normally made by the employer.

Contributory defined benefit deal – the employee is promised a pension benefit normally determined by a formula based on a combination of salary and years of service. Because the employee contributes to the pension fund, the pension benefit may be better than under a pure defined benefit deal.

The employee and the employer both contribute towards the cost of the pension benefit. The employee's contributions are fixed, while the employer's contributions vary depending upon a number of factors, including the investment performance of the pension fund.[2]

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[1] See also *The Nature of the Pension Agreement*, Research Report #1, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987).

[2] Under the Pension Benefits Act, 1987, at least 50 per cent of the pension benefit in respect of years after 1986 must be provided by employer contributions plus investment earnings thereon. However, this is not a requirement that the employer's contributions must at all times match or exceed the employee's contribution. The calculation is based on the entire period of the plan member's employment.

Normally, the interest of plan members in the pension fund is limited to ensuring that the employer's funding policy and the pension fund itself are and will be adequate to provide the pension benefits promised. Consequently, normally, the employer alone benefits from a surplus (e.g. through a withdrawal of surplus or decreased future contributions) and bears the burden of a deficit (through increased contributions) in the pension fund.

Decisions relating to pension fund structure and investment policy are normally made by the employer.

Combined Defined Benefit/Asset Related Pension Deals

Hybrid deal – the employee is promised a pension benefit equal to the aggregate of:

- the pension benefit that can be provided by employer and employee contributions plus investment earnings thereon (asset related), and
- if the asset related benefit is less than a minimum pension benefit, normally determined by a formula based on a combination of salary and years of service, an additional pension benefit equal to the shortfall (defined benefit related).

The employer and the employee make fixed (and normally matching) contributions to the pension fund for the asset-related component of the deal. Normally, the employer alone makes contributions to the pension fund for the defined benefit-related component of the deal.

A surplus or a deficit can arise from the defined benefit related component of the deal, but not from the asset related component. Normally, the interest of plan members in the pension fund for the defined benefit component of the deal is limited to ensuring that the employer's funding policy and the pension fund itself are and will be adequate to provide the minimum pension benefits promised. Consequently, normally, the employer benefits from a surplus (through a withdrawal of surplus or decreased future contributions) and bears the burden of a deficit (through increased contributions) in the pension fund for the defined benefit related component of the deal.

Decisions relating to pension fund structure and investment policy are normally shared.

Shared risk/reward defined benefit deal – the employee is promised a pension benefit normally determined by a formula based on a combination of salary and years of service.

The employer and the employee make fixed (and normally matching) contributions to the pension fund.

The employer and the employee share the benefit of a surplus (e.g. through decreased contributions or increased benefits) and the burden of a deficit (through increased contributions or decreased benefits) in the pension fund.

Decisions related to pension fund structure and investment policy are normally shared.

Asset Related Pension Deals

Multi-employer deal – the employer and (sometimes) the employee make fixed contributions to a pension fund established for employees in the same industry (e.g. the construction industry). The level of contributions is normally determined by a formula based on a combination of wages and hours worked.

Once he has made his agreed contributions, the employer has no further obligation to contribute regardless of the investment performance of the pension fund. However, the employer will have an interest in the investment performance of the pension fund if investment performance could result in plan members receiving pension benefits that are perceived by them to be less than adequate. This could give rise to demands for supplemental pension benefits for retirees and increased employer contributions for plan members.

The employee is promised a pension benefit normally determined by a formula based on a flat benefit for a fixed number of hours of service. The pension benefit promised to active plan members may be increased or decreased if the investment performance of the pension fund is better or worse than anticipated.

Since the pension benefit payable to plan members is based on the assets available in the pension fund and not on a formula based on salary and years of service, no surplus or deficit arises in the way it does in a defined benefit related deal.

Decisions relating to pension fund structure and investment policy are normally made by the employees' union.

Defined contribution (or money purchase) deal – the employer and (commonly) the employee make fixed contributions to a pension fund established by the employer for his employees. The level of contributions is normally determined by a formula based on salary (although there may be discretionary contributions as well).

Once he has made his agreed contributions, the employer has no further obligation to contribute regardless of the investment performance of the pension fund. However, the employer will have an interest in the investment performance of the pension fund if investment performance could result in plan members receiving pension benefits that are perceived by them to be less than adequate. This could give use to demands for supplemental pension benefits for retirees and increased employer contributions for plan members.

The employee is promised the pension benefit that can be provided by employer and employee contributions plus investment earnings thereon.

Since the pension benefit payable to plan members is based on the assets available in the pension fund and not on a formula based on salary and years of service, no surplus or deficit arises in the way it does in a defined benefit related deal.

Since employees bear the investment risk, one would expect that decisions relating to pension fund structure and investment policy would be made by the employees. In practice, these decisions are normally made by the employer, though employees may be allowed to make investment decisions within a range of specific investment alternatives (e.g. a bond, stock or mortgage fund).

Summary

Figure 3.3 illustrates who normally benefits from a surplus and bears the burden of a deficit for each of the three categories of pension deals.

Who Normally Benefits From a Surplus and Bears the Burden of a Deficit

Defined Benefit Related Deals	Combined Defined Benefit/ Asset Related Deals	Asset Related Deals
Pure Defined Benefit · Contributory Defined Benefit	Hybrid* · Shared Risk/ Reward	Multi-Employer · Pure Defined Contribution
Employer	**Shared**	**No Surplus (Deficit)**

* A surplus or a deficit can arise only from the defined benefit related component of a hybrid deal, not the asset related component. The employer benefits from a surplus and bears the burden of a deficit.

FIGURE 3.3

For defined benefit related deals, the employer normally benefits from a surplus and bears the burden of a deficit. For combined defined benefit/asset related deals, a surplus or deficit is normally shared, while for asset related deals, there is no surplus or deficit.

Who Should Have Primary Decision-Making Control:

The Task Force believes that whoever bears the risk or liability should control pension fund decision-making. This means that one would expect that for defined benefit related deals, the employer/plan sponsor would control decision-making or appoint those who make the decisions; for combined defined benefit/asset related deals, decision-making would be shared; and for asset related deals, employees would control decision-making or appoint those who make the decisions. See Figure 3.4.

Who One Would Expect to Make Decisions Relating to Pension Fund Structure and Investment Policy

Defined Benefit Related Deals	Combined Defined Benefit/ Asset Related Deals	Asset Related Deals
Pure Defined Benefit · Contributory Defined Benefit	Hybrid* · Shared Risk/ Reward	Multi-Employer · Pure Defined Contribution *
Employer	**Shared**	**Employee**

* In practice, these decisions are normally made by the employer.

FIGURE 3.4

SECTION IV

Public Sector Pension Deals

Of the six kinds of pension deals, all but the multi-employer deal are used in the Ontario public sector.

Figure 3.5 classifies Ontario's 86 public sector pension plans by the kind of pension deal: 49 are defined benefit related; 11 are combined defined benefit/asset related and 26 are asset related.

Kinds of Ontario Public Sector Pension Deals

Defined Benefit Related Deals		Combined Defined Benefit/ Asset Related Deals		Asset Related Deals	
Pure Defined Benefit	Contributory Defined Benefit	Hybrid	Shared Risk/ Reward	Multi-Employer	Pure Defined Contribution
1 Plan	48 Plans	9 Plans	2 Plans	0 Plans	26 Plans

FIGURE 3.5

The classification is based on information provided to the Task Force and a review of the formal pension deal of the major plans. The classification assumes that current practice is consistent with the formal pension deal.

Some of the plans associated with the seven funds included in our terms of reference are difficult to classify, either because the plan does not fit neatly into one of the six kinds of deals described above (e.g. TSF and PSSF) or because certain aspects of current practice suggest that a deal somewhat different from the formal deal (e.g. OMERS) is actually in effect. Nonetheless, we have classified these plans as contributory defined benefit deals.

SECTION V

Roles of Government

In varying degrees, the Government plays seven major roles in connection with Ontario's public sector pension plans:[3]

Role 1: **legislator/regulator**

Role 2: **plan sponsor**

Role 3: **employer**

[3] See Appendix G, *The Many Roles of Government*, for a more complete list of the government's pension roles.

Role 4: contributor to the pension fund

Role 5: guarantor of its own or another employer's pension promise

Role 6: source of funding for another employer

Role 7: guarantor of another employer's debt

In its legislator/regulator role (Role 1), the Government has committed itself, through the Pension Benefits Act, to set and enforce the same rules in relation to public sector pension plans as it does in relation to private sector pension plans. As we will see in later chapters, the fact that some public sector pension plans are invested in non-market government debt is not consistent with that commitment.

In addition to these roles, the Government is the borrower of all of the TSF, PSSF and SAF and a residual part of OMERS. In total, the Government debt owed to these four funds is over $17 billion.

Figure 3.6 sets out the Government's roles (Roles 2 through 7) in relation to the seven public sector pension funds included in our terms of reference.

The Government's Roles in Relation to Seven Public Sector Pension Funds

ROLE / PLAN	Plan Sponsor	Employer	Contributor to the Pension Fund	Guarantor of the Pension Promise	Source of Funding for Another Employer	Guarantor of Another Employer's Debt
TSF	yes	no [1]	yes [2]	yes	yes	no
PSSF	yes	yes [3]	yes [2]	yes	yes	yes [4]
SAF	yes	yes [5]	yes [2]	no	yes	yes [4]
OMERS	yes	no	no	no	partial [6]	no [6]
HOOPP	no	no	no	no	yes	no
HYDRO	no	no	no	no	no	yes
WCB	no	no	no	no	no	no

[1] The Government is the employer for pension purposes for teachers employed by 169 school boards.
[2] The Province is not the only contributor to the TSF, PSSF and SAF.
[3] The Province is not the only employer contributing to the PSSF. Several boards, agencies and commissions also contribute as employers.
[4] In the sense that the Province with its taxing power is the source of funding for these plans.
[5] The Province is not the only employer with employees who benefit from the SAF. Teachers and Ryerson employees benefit as well.
[6] 1,069 employers participate in OMERS, including those whose only source of funding is the Province, those with other sources of funding (e.g. municipalities with their local tax base), and those which receive no provincial funding (e.g. municipal electric utilities).

FIGURE 3.6

Six observations can be made based on Figure 3.6:

- The Government is the plan sponsor for only four of these seven plans – the TSF, PSSF, SAF and OMERS.
- The Government is the employer with respect to only two plans – the PSSF and SAF – and even here it is not the only employer involved in those plans.
- The Government is a direct contributor to only three funds – the TSF, PSSF and SAF – and provides a statutory guarantee that the pension promise will be honoured for only two plans – the TSF and PSSF.

- The Government, in whole or in part, provides funding to other employers involved in five of these seven plans – the TSF, PSSF, SAF, OMERS and HOOPP.
- The Government is the guarantor of certain non-pension debt obligations of HYDRO. (The Government is also the guarantor of the debt of certain other public sector institutions, e.g. universities.)
- Outside of its legislative role, the Government can determine the structure of only four of the 86 public sector pension funds – the TSF, PSSF, SAF and OMERS.

SECTION VI

Taxpayer's Stake

There are many interested parties, but only two principals, in relation to the investment of Ontario's public sector pension funds, namely plan members and the taxpayer. All others – unions, trustees, investment managers, even plan sponsors and employers – are for the most part agents or representatives of one of the principals, and sometimes of both.

The Ontario taxpayer has a major stake in the Task Force's review because:

- The Federal and Ontario Governments promote the accumulation of assets to provide pension benefits through tax deferral incentives contained in the Income Tax Act (Canada).
- The Ontario Government regulates the operation of pension plans.
- Employer contributions to most public sector pension funds come from tax receipts. For some funds, employer contributions come in whole or in part from specific groups (e.g. Ontario Hydro electrical consumers, Workers' Compensation Board employers, university and college students, hospital donors and patients). The term "taxpayer" is meant to include all of these.

Given this major taxpayer stake, the Task Force believes that the Ontario taxpayer would want to approach public sector pension fund issues with the following principles in mind:

- that public sector employees be treated fairly
- that the full cost of public sector pension benefits be known and be identified as a component of total compensation
- that the taxpayer's interest be adequately taken into account in pension fund decision-making
- that the cost to the taxpayer of providing public sector pension benefits be as low as possible
- that the taxpayer not be asked to assume a disproportionate share of the risk of providing a pension.

SECTION VII

Pension Entitlement as Part of Total Compensation

This section addresses the question of whether employer contributions to a pension fund are an accurate measure of the wage equivalent value of an employee's pension entitlement. The employee's pension entitlement is a component of his total compensation.

An employee's total compensation is a combination of:

- direct compensation – salary or wages
- indirect compensation – the wage equivalent value of vacation pay, paid statutory holidays and life, health and disability insurance benefits
- deferred indirect compensation – the wage equivalent value of the pension entitlement.

Total compensation can be arrived at either through explicit employer/employee negotiation of the compensation package, or through independent decisions on specific components, or both.

Figure 3.7 illustrates a typical total compensation package.

Components of Total Compensation

FIGURE 3.7

The wage equivalent value of an employee's pension entitlement can be estimated, using actuarial assumptions and valuation methods. The contributions an employer is required to make or actually makes in a period are not necessarily a good estimate of that value. In our view, the employer's pension expense for accounting purposes for the period is a practical proxy for the wage equivalent value of an employee's pension entitlement.

Employer's Pension Expense

In April 1986, the Canadian Institute of Chartered Accountants (CICA) recommended a method for determining an employer's pension expense.[4]

The CICA recommendations differ for asset related and defined benefit related pension deals.

[4] *CICA Handbook: Pension costs and obligations, Section 3460* (Canadian Institute of Chartered Accountants, April 1986).

For asset related deals, the CICA recommends that an employer's pension expense for a period be the employer's required contribution to the pension fund in respect of the period.

For defined benefit related deals, the CICA recommends that an employer's pension expense for a period be the sum of:

- the cost of the pension benefit provided in respect of the employee's services in the period. This cost is determined by using one of the accrued benefit methods of actuarial valuation (namely the projected benefit method pro-rated on years of pensionable service)[5], and
- adjustments required as a result of plan amendments, changes in actuarial assumptions and gains and losses attributable to differences between expected plan experience (determined using the actuarial assumptions) and actual plan experience.

The CICA's objective is to provide guidelines for a proper accounting allocation for employers of the cost of a pension plan to the years in which related employee services are rendered.

Many of the actuarial valuation methods rejected by the CICA continue to be used for funding purposes, i.e. to determine the minimum amount the employer must contribute to the pension fund for the period to provide for the pensions promised.

An employer's objective in funding a pension plan is to provide an adequate fund for the pensions promised, consistent with his cash availability, with the funding standards prescribed under the Pension Benefits Act and with the requirements of the Income Tax Act (Canada). Consequently, his actual contributions to the pension fund for a period may be more or less than his pension expense for accounting purposes for the period or his legally required minimum contributions for the period.

Task Force's Observations

1. In defined benefit related deals, an employer's contributions to a pension fund are not an accurate measure of the wage equivalent value of an employee's pension entitlement. An employee's pension entitlement for a period may be

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[5] The actuarial valuation method selected by the employer has a significant impact on the cost of pension benefits allocated to a specific time period. The two main families of actuarial valuation methods are:

- level contribution methods: under these methods, the pension cost allocated to any period is either the same dollar amount or the same percentage of compensation as any other period, and is a portion of the cost of the total future benefits of an employee group, either in absolute dollars or as a percentage of salary, and
- accrued benefit methods: under these methods, a unit of retirement benefit is allocated to each period and the present value of that unit of benefit is separately computed (i.e. the amount of the unit of benefit is discounted from retirement date to the date of the determination using a discount rate based on the interest or investment return assumption included in the actuarial assumptions).

The difference between the two families of valuation methods is that:

- under the level contribution methods, the employer's pension cost remains constant (either in absolute dollars or as a percentage of salary) over the employee's period of employment, and
- under the accrued benefit methods, the employer's pension cost rises over the employee's period of employment.

more or less than the contributions required to be made or actually made by the employer to the pension fund in the period.

2. Actuarial surpluses and deficits resulting from actual experience being different from actuarial assumptions are to be expected in defined benefit related deals, since the actuarial assumptions used to determine the amount of the total pension benefits that will be ultimately payable under the plan are intended to apply over a long period. Because short-term experience varies from projected experience does not necessarily mean that the actuarial assumptions will prove incorrect over the long term or that employees' total compensation will be more or less than anticipated.

SECTION VIII

Ownership of a Surplus (Deficit)

Since investment performance can contribute to a surplus (deficit) in a pension fund, there is a direct link between pension fund investment and the issue of who owns a surplus (deficit). In addition, the determination of who owns a surplus (deficit) helps to answer the question: In whose interest are pension fund investments made?

This section discusses ownership of a surplus (deficit) under the following headings:

- Nature of a surplus (deficit)
- Who owns a surplus?
- Task Force's observations.

Nature of a Surplus (Deficit)

The issue of ownership of a surplus (deficit) arises in relation to defined benefit related deals. In pure defined benefit related deals, the employee does not contribute directly to the cost of the pension promised. Accordingly, the employee's claim to a surplus, if any, is more limited than in contributory defined benefit deals.

In combined defined benefit/asset related deals, the issue normally has been resolved in advance or a mechanism exists to deal with it. In asset related deals, there is no surplus (deficit).

A surplus (deficit) arises in two situations: on a valuation of an ongoing plan and on a plan termination or wind-up. We have restricted ourselves to situations where a surplus (deficit) arises on a valuation of an ongoing plan because, at least with respect to the seven public sector funds included in our terms of reference, a plan wind-up is not likely.

Contributions

Pension benefits in contributory defined benefit related deals are provided through a combination of employer and employee contributions and investment earnings. Employee contributions may be established unilaterally by the employer or agreed to between the employer and his employees. In some circumstances, employee contributions may be intended to fund a specified portion of the cost of the benefits

promised. In such cases, there is a relationship between the actuarial assumptions and employee contributions.

Employer contributions are normally established on the advice of the plan actuary using actuarial assumptions. These assumptions may or may not reflect the total cost of the future pension benefits. (See Section VII) The actuary also chooses a valuation method which seeks to distribute contributions over time in a manner which is consistent with the requirements of the Pension Benefits Act and with actuarial standards.[6]

Best Estimate Actuarial Assumptions and Funding Actuarial Assumptions

The actuarial assumptions are assumptions about future events that will affect pension costs and contribution rates and include such matters as investment return, mortality, withdrawal rates, future salary increases (including inflation), retirement ages, and levels of social security benefits.

Best estimate actuarial assumptions are the basis for estimating the cost to the employer, or the value to the employee, of pension entitlements. Funding actuarial assumptions are the basis for establishing a smooth pattern for plan funding over time (i.e. contribution rates). Three measure then – pension cost, value of pension entitlements and pension contributions – are to be distinguished in terms of the actuarial assumptions used.

In our view, an investment policy that is essentially risk free in the context of the plan liabilities should be used for establishing the best-estimate actuarial assumption about investment return. For example, the rate of return of Treasury Bills is considered essentially risk free when plan liabilities are inflation sensitive.

We recognize this approach departs from current practice. However, investment risk is an opportunity cost. This cost is not now generally recognized and accounted for in determining employer pension costs and valuing pension entitlements. (See Appendix H.)

Best Estimate and Funding Valuations of Pension Plans

Under the new CICA rules, most pension plans must be valued annually, on a best estimate basis. Under the Pension Benefits Act, the actuary is required to value the pension plan at least every three years, in order to assess plan solvency and to see if adjustments need to be made to the plan funding pattern (i.e. contribution rate). Generally, valuations are comparisons of:

- the present value of the liabilities accumulated under the pension plan up to the valuation date, determined using either the best estimate or the funding actuarial assumptions and the appropriate actuarial valuation method, and
- the value of the assets of the pension fund on the valuation date.

If the present value of the liabilities exceeds the assets, the plan has a deficit. If the assets exceed the present value of the liabilities, the plan has a surplus. Since both best estimate and funding actuarial assumptions are intended to operate over an extended period of time, actual experience up to a valuation date is likely to differ from projected experience. Accordingly, it is likely that, at the time of a valuation, a plan will have a surplus or a deficit with both best estimate and funding valuations.

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[6] As noted in the previous Section, the employer's actual contributions may not be the same as his pension expense in a particular period. This could occur because of other financial considerations of the employer or, on the advice of the actuary, in order to provide a smooth build-up of the fund over many years.

Investment Policy

The governors of the pension fund may select an investment policy that has more risk than the investment policy assumed in establishing the best estimate rate of return assumption. This would be done in an attempt to achieve a greater investment return. The result of a higher risk investment policy at any time could be a greater or lesser investment return than the risk-free rate of return and thereby a larger or smaller surplus (deficit) than would have occurred had such policy not been selected.

Parts of a Surplus (Deficit)

For the purposes of our discussion of who owns a surplus, in circumstances where the governors of the pension fund select an investment policy that has more risk than an investment policy that is essentially risk free, we consider any surplus or deficit to have two parts:

- the portion attributable to the selection of an investment policy that has risk (i.e. the difference between the actual investment return and the investment return that would have resulted if the pension fund governors had selected an investment policy that was essentially risk free) – this we call the investment risk surplus or investment risk deficit, and
- the remainder, which reflects the difference between actuarial assumptions (including the assumption about what the risk-free rate of return will be) and actual plan experience – this we call the actuarial surplus or actuarial deficit.[7]

Figure 3.8 illustrates the parts of a surplus.[8]

Conceptual Parts of a Pension Fund Surplus

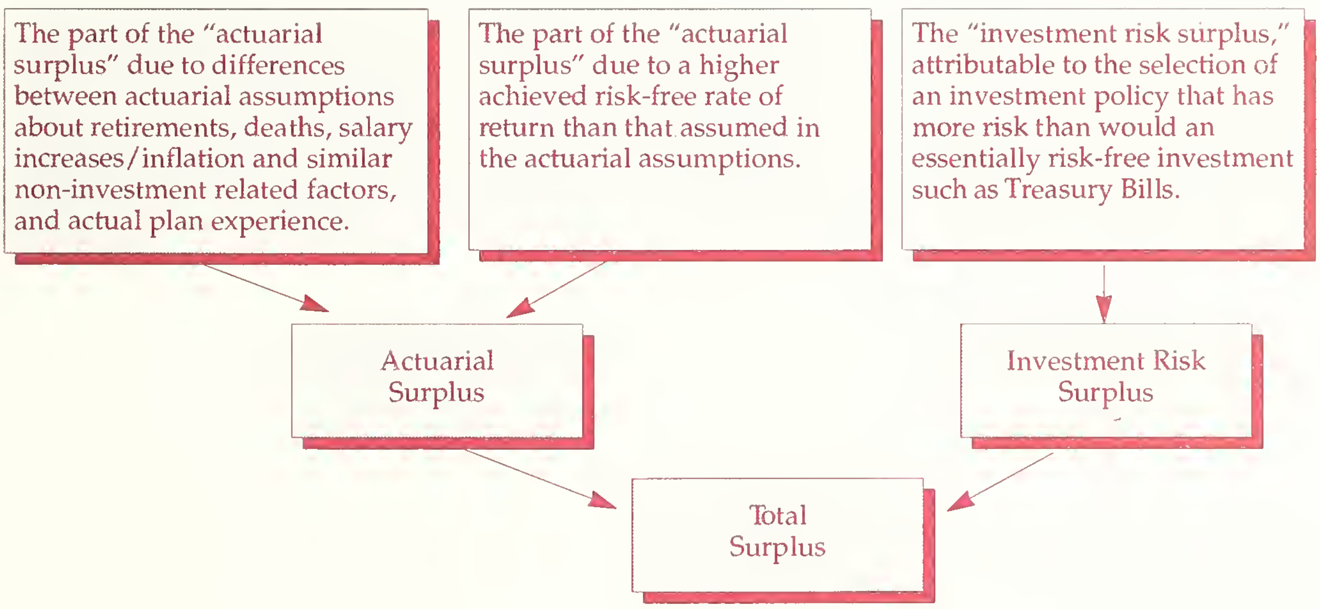

FIGURE 3.8

[7] Employers sometimes contribute more to the pension fund than the minimum they are legally required to contribute. They may do this to smooth their future cash flow requirements, or for tax advantages (which are not generally applicable in the public sector). In effect, this is a form of prefunding future contributions, and may be part of an actuarial surplus.

In addition, employees and/or employers may over-contribute to the pension fund as a result of conservative actuarial assumptions. This may lead to an actuarial surplus due to overfunding.

[8] See Appendix H, *An Economic Framework for Establishing Surplus Ownership.*

The distinction between an investment risk surplus and an actuarial surplus is useful in assessing who may be entitled to benefit from a surplus. However, it may be impractical to determine precisely the respective entitlements of employers and plan members (and of various classes of plan members) to an existing surplus. As well, it is possible that an investment risk deficit could occur at the same time as an actuarial surplus, and vice versa. If one party is responsible for the deficit and another party is entitled to the surplus, a cross subsidy could arise.

Who Owns a Surplus?

Ownership of a surplus in the context of public sector pension plans normally refers to the following:

- in the case of the employer, the right to withdraw the surplus; to apply the surplus to reduce future contributions; to choose to use the surplus as a source of money to pay for improvements in pension benefits without affecting cash flow; or to serve as a cushion against future contingencies; and
- in the case of the plan members, the right to have the surplus applied to increase pension benefits or to reduce future contributions.

The debate over the ownership of a surplus is summarized below under the following headings:

- general perception of the pension deal
- economic perception of the pension deal.

General Perception of the Pension Deal

Most employers believe that the pension deal simply entitles employees to the pension promised. This perception (described as "you are only entitled to the pension promised") may be supported by the plan and fund documentation.

However, many plan members believe that the pension deal vests ownership of all contributions and investment earnings in the plan members. This perception (described as "it's our fund") may be prompted or supported by the plan and fund documentation, which may have been written that way in error or for reasons which are no longer clear or relevant.

Either perception may be based wholly or in part on self-interest, particularly if the plan and fund documentation is unclear and there is a large surplus. Often both perceptions legitimately co-exist. This is not surprising given the usual lack of attention to such matters at the time the pension deal is established and the plan documentation written.

Economic Perception of the Pension Deal

Most employers believe that they own a surplus for four basic reasons:

- First, they have promised their employees only a specific pension benefit and any assets in the fund beyond what is needed to pay for that pension benefit is a surplus to which they are entitled.
- Second, because they have the obligation to fund any deficit, they are entitled to the benefit of any surplus.
- Third, because they run the investment risk associated with the investment policy of the pension fund, they are entitled to the benefit of any investment reward in the form of an investment risk surplus.

- Fourth, part of the surplus may have resulted from prefunding of contributions by the employer over a period of years (i.e. the employer may have made greater contributions than he was legally required to do in anticipation of the day when his non-pension cash requirements would be greater).

Employees offer two counter-arguments.

The first is that, in a total compensation context, it is not the employer who bears the ultimate burden of a deficit but rather the employees, in the form of reduced wages and benefits. This is the view taken by the Ontario Federation of Labour (OFL) in its brief to the Task Force:

> "The ultimate burden of higher pension costs is clearly borne, at least in part, by employees . . . (and) we should certainly base public policy on the realistic premise that workers bear risks and share losses. There can be no validity to the employers' claim that they should enjoy unfettered use of surpluses."[9]

This argument is often balanced by the observation of others that the existence of a surplus suggests good employer financial health and leads to improved total compensation.

The second employee counter-argument has two parts:

- First, it is claimed that because employees contribute to the pension fund, they should share in any surplus resulting from good investment performance. The OFL in its brief argues that investment earnings are generated as much by employee contributions as by employer contributions.
- Second, it is argued that conservative actuarial assumptions result in employees paying a larger share of the total cost of the pension benefits promised than would otherwise have been required if realistic actuarial assumptions had been used.

This second counter-argument is rejected by others who say that employee contributions are not normally determined with reference to the actuarial assumptions and that the employees do not have to share the burden of any deficit.

Task Force's Observations

The Task Force has the following observations on who owns a surplus in the context of public sector pension plans:

1. Conceptually, a surplus can have two parts:
    - investment risk surplus – the difference between the actual investment return and the investment return that would have resulted if the pension fund governors had selected an investment policy that was essentially risk free; and
    - an actuarial surplus – the remainder of the surplus.[10]

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[9] Ontario Federation of Labour (OFL) Brief to the Ontario Task Force on the Investment of Public Sector Pension Funds, March 2, 1987, page 19.

[10] Part of an actuarial surplus may result from deliberate prefunding of contributions by the employer. We consider this to be part of the employer's share of the actuarial surplus. Another part of an actuarial surplus may result from over-contributions by employers and/or employees, due to conservative actuarial assumptions.

2. The existence of a surplus should be considered with a full understanding of how the surplus arose. Actuarial surpluses and deficits are to be expected since actuarial assumptions are intended to apply over a long period. It should be recognized that the circumstances that gave rise to a surplus will likely change with fluctuations in the economy or other factors. Deficits were the norm in the late 70's and early 80's. Surpluses seem to be the norm in the mid 80's.[11] It may therefore be prudent not to distribute an actuarial or investment risk surplus but to leave part or all of it as a cushion against future contingencies.

3. The party who bears the risk associated with a pension fund's investment policy should receive the investment risk surplus and bear the burden of the investment risk deficit. There are practical difficulties associated with ensuring that any investment deficit is assumed by the party claiming the investment risk surplus and is not transferred to the other party through increased contributions or other means.

4. If employer and/or employee contributions are set in relation to conservative (rather than best estimate) actuarial assumptions, leading to an actuarial surplus, employers and employees are entitled to share that part of the actuarial surplus that results from their over-contributions.

5. Through explicit or implicit total compensation decisions, there could well be a shift of the cost of a deficit from the employer to the employee. Equally, there could be a shift of the benefit of the employer's share of a surplus from the employer to the employee. However, there are practical difficulties associated with measuring a shift to plan members of any deficit (in the form of reduced wages and benefits) or any surplus (in the form of increased wages and benefits). Moreover, the impact of a shift to plan members is likely to occur over time.

6. There is an argument that pensioners should share in that portion of an actuarial surplus that is inflation induced.[12]

7. There is no single or simple means of deciding who owns a surplus in all circumstances. It may be impractical to determine precisely the respective entitlements of employers and plan members (and of various classes of plan members) to an existing surplus. For the future, the key lies in having a pension deal which is clear and in understanding what that deal is. This will not be easy in all circumstances and may require considerable effort by the parties involved.

   If the formal pension deal is not clear, or if the parties are not satisfied with the pension deal as it relates to ownership of a surplus (deficit), the parties should consider changing the pension deal.[13]

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[11] See Chapter 6 for a comparison of surpluses and deficits and of employer/employee contribution rates for six public sector pension plans for the period 1976-1987.

[12] An arithmetic illustration of the effects of inflation on pension recipients, contributors and plan sponsors in non-indexed and indexed plans, is provided in a paper by John Ilkiw, *Inflation, Indexation, Income Redistribution and Pension Plan Valuations* (Ontario Ministry of Treasury and Economics, 1979).

[13] We note in this regard that the Pension Benefits Act, 1987 (Section 10(10)) requires that the plan documentation set out the treatment of surplus both for ongoing plans and on plan wind-up.

Recommendation 3.1

Public sector employers should review their pension deal to determine whether the component of the deal relating to ownership of a surplus (deficit) is clear. Where this component is not clear, public sector employers should discuss changes to the deal with employees to make this component clear.

SECTION IX

Changing the Pension Deal

This section looks at how pension deals are changed in the public sector, who is entitled to change them and when.

Since we deal in this report only with existing deals, the Task Force has not explored the process for establishing a new pension deal.

Changing a pension deal can be achieved in one of three ways:

- unilaterally by the employer
- by negotiation such as:
  - collective bargaining
  - formal discussion
  - informal discussion
  - political bargaining and legislation
  - a combination of the above
- hidden or "evolutionary" changes.

For the most part, each of these ways of changing the deal is self-explanatory. However, formal and informal discussion and hidden or evolutionary changes may need further explanation.

Formal discussion refers to the relationship which has evolved between Ontario's teachers and the Ministry of Education. Collective bargaining on pension matters is prohibited, but formal discussions on pension matters take place.

Informal discussion refers to the past relationship between public servants and the Management Board of Cabinet. Collective bargaining on pension matters is prohibited, but informal discussions on pension matters took place. These discussions now have been formalized.

Hidden or evolutionary changes refers to changes which occur or evolve through interpretation of the pension deal.

The process for changing public sector pension deals is complicated by the facts that:

- many pension deals can only be changed by legislation, by the approval of the Lieutenant Governor in Council, or by some other government action, and

- eighty-eight per cent of public sector employees belong to plans, the benefits of which are not negotiable, either because collective bargaining is prohibited or because the structure of the industry makes collective bargaining impractical.

Figure 3.9 indicates how many plans of each type are negotiable and the number of employees and assets in each category.

Negotiability of Public Sector Pension Deals

Pension Deal	Defined Benefit	Defined Contribution	Combined	Total	% of Total
Negotiable					
• Plans	13	9	4	26	30
• Active Plan Members	36,911	4,005	11,865	52,781	10
• Assets ($ Billion)	4.60	0.28	0.88	5.76	15
Non-Negotiable					
• Plans	30	10	5	45	52
• Active Plan Members	462,700	100	3,656	466,456	88
• Assets ($ Billion)	29.92	0.002	0.40	30.32	82
No Information					
• Plans	6	7	2	15	18
• Active Plan Members	6,230	257	3,039	9,526	2
• Assets ($ Billion)	0.64	0.008	0.31	0.96	3

- Active Plan Members as of December 31, 1985.
- Assets at market value as of December 31, 1986, except for non-market government debt which is at book value.

FIGURE 3.9

The OFL believes that the term "pension deal" is meaningless for most public sector employees, since they do not have the right to bargain the terms and conditions of their deal. However, public sector employees have accepted the terms and conditions of their employment, one of which, in most cases, is no collective bargaining on pension matters. In this respect, there is a deal.

The issue really is, how should that deal be changed? The OFL believes that:

- "employees should have the right to choose collective bargaining as the means by which their terms and conditions of employment are established", including pension issues[14]

[14] OFL Brief, p. 11.

- collective bargaining on pension issues "embraces not only plan design but also plan administration, asset management and the utilization of surpluses."[15]

In short, the OFL supports a process for changing all aspects of the deal, as necessary, and as part of collective bargaining.

Not all employee groups agree with the OFL. The Ontario Teachers Federation is one. Clearly, it will be difficult, if not impossible, to satisfy everyone. However, this should not be a reason for maintaining the status quo.

Public sector pension deals are now changed in a variety of ways. Some involve direct employer/employee negotiation, others involve cumbersome legislative action with little employee/employer negotiation in a traditional sense.

It is in the interest of both employees and employers to be able to change all or part of the pension deal from time to time. Indeed, in subsequent chapters, we recommend that particular employee groups be asked whether they want to change the kind of pension deal they now have.

After assessing the pros and cons, the Task Force believes that the issue of how to change the deal and what to change should be divided into two parts:

- discussions with employees on the kind of pension deal or deals the employer should offer
- negotiations or discussions with employees, within a total compensation framework, on changes to benefit and funding levels.

Each of these parts is discussed in greater detail below.

Discussions around the Kind of Pension Deal

A pension deal by its nature is designed for the long haul. As such, it is inappropriate to change its basic composition frequently (e.g. to change the deal from a defined benefit related deal to a defined contribution related deal and back again). A measure of stability is essential.

There is a practical limit to the number of pension options employees can and should be offered. There is also a practical limit to how often the pension deal should be altered in a fundamental way.

However, there appears to be a trend to, and a demand for, greater choice in benefit packages offered to employees. Given this trend, there may be merit in public sector employers offering employees a choice of pension deals. For example, a choice between a defined benefit deal and a defined contribution deal. It would be up to employees to elect which deal suited their needs best.

Recommendation 3.2

Public sector employers should be amenable to discussing changes to the current pension deal with their employees if their employees indicate a desire for change.

[15] OFL Brief p. 2.

Changes to Benefit and Funding Levels

Within a particular pension deal, elements such as benefit and funding levels should be considered as part of total compensation. Decisions on these elements can be reached in any of several ways, including collective bargaining and formal or informal discussions with employees or their representatives.

Recommendation 3.3

To the extent possible, benefit and employee contribution levels should be negotiated or discussed between the employer and employees as part of total compensation.

Suggesting that changes to public sector pension deals be made within a total compensation context raises the question whether public sector pensions should be bargained collectively as recommended by the OFL. This would be a dramatic departure from past practice, as only about 10 per cent of public sector plan members now have that right.

Obviously, a change of this nature should not be taken without careful consideration. Collective bargaining for salaries and other elements of compensation already is complex enough in the public sector.

In view of this complexity and the fact that others have the responsibility to address this question, the Task Force is not in a position to respond to the urging of the OFL to support collective bargaining on pension issues. For those who are charged with this issue, we have the following observations:

- We believe that the taxpayer has much to gain from having salary and pension benefits considered at the same time, provided that collective bargaining is conducted in a marketplace environment where employers and employees jointly make the final decisions.
- Many public sector services are considered essential and the right to strike or lock-out is not permitted. In such cases, the law provides for arbitration of disputes which cannot be resolved between the two parties.
- Given the long-term nature of pension obligations and the complexities of actuarial valuation of pension liabilities, there are real dangers in referring pension issues along with salary issues to arbitration. An arbitrator is not directly accountable to the taxpayer for his/her decisions.
- In our view, arbitration on pension issues (rather than the right to strike or lock-out) would not be in the taxpayer's interest. Because the great majority of public sector employees have defined benefit related pension deals, decisions on defined benefit pensions are different from decisions on salaries in two important ways:
  - The pension decision involves deferred compensation. The obligation is long term and only a small portion of the cost of any change will arise in the period being bargained for.
  - The pension promise is a defined benefit to be paid starting on retirement, rather than a specific employer contribution, so it is impossible to know today what the eventual full cost to the employer will be.

Conclusion

This chapter reviewed the components of the pension deal; the various kinds of pension deals including those operative in the public sector; the roles of government; the taxpayer's stake; the pension entitlement as part of total compensation; the issue of ownership of a surplus; and the way pension deals are changed.

Our principal conclusions from this chapter are:

- Given that the basic purpose of a pension fund is to provide the assets from which to pay the pension benefits promised, both plan members and employers have an interest in the security of the investments of the pension fund.
- There are three types of pension deals: defined benefit related; combined defined benefit/asset related; and asset related.
- One needs to understand the kind of pension deal to know the nature and extent of each participant's interest in that deal.
- The wage equivalent value of the pension entitlement component of total compensation is the employer's pension expense for accounting purposes.
- In defined benefit related deals, an employer's contributions to a pension fund are not an accurate measure of the wage equivalent value of an employee's pension entitlement.
- Actuarial surpluses and deficits, resulting from actual experience being different from actuarial assumptions, are to be expected in defined benefit related deals. However, this does not necessarily mean that the actuarial assumptions will prove incorrect over the long term or that employee's total compensation will be more or less than anticipated.
- Decisions on investment policy should be made in the interest of whoever bears the investment risk. Who bears the investment risk varies depending on the type of deal. Normally, in the formal pension deal, investment risk is borne as follows:
  - Defined benefit related deals – Employer bears risk
  - Combined deals – Employer and employee share risk
  - Asset related deals – Employees bear risk
- A formal pension deal is documented in several ways. Such documentation may not conform to employees' or employers' views or assumptions about what the deal is. Current practice often is not consistent with the formal pension deal. Misunderstanding and disagreement can easily occur in such circumstances.
- Ownership of a surplus (deficit) in a pension fund is a component of the pension deal and is a key factor in determining in whose interest investment risk decisions are made. However, it is often the least clearly set out of the components of a formal pension deal, and the most hotly contested, particularly in contributory defined benefit deals with surpluses. When ownership of a surplus (deficit) is not clear, it is in the interest of both plan members and

the taxpayer to clarify the formal deal, or to consider changes to the formal deal which will make this component clear.

- It is useful to think of a surplus as having two parts:
  - an investment risk surplus derived from taking a level of risk above that related to an investment policy that is essentially risk free (and therefore anticipating increased variability in returns), and
  - an actuarial surplus resulting from actual experience being better than projected in the actuarial assumptions.[16]
- In economic terms, an investment risk surplus should accrue to whoever bears the investment risk.
- In economic terms, employees may be entitled to a share of an actuarial surplus to the extent that their contributions are intended to fund a portion of the pensions promised and to the extent that their excess contributions contributed to the surplus.
- It is may be impractical to determine who is entitled to how much of an existing surplus. However, the distinction between an investment risk surplus and an actuarial surplus can be helpful to employers and employees in clarifying the pension deal so that ownership of any future surpluses can be resolved more readily.
- There could well be a shift of the liability for a deficit (or of the benefit of a surplus), through subsequent total compensation decisions, from the employer to the employees. However, such a shift is almost impossible to quantify.
- Public sector employers are agents of the taxpayer. It is the taxpayer, therefore, who has a major stake (along with plan members) in the investment of Ontario's public sector pension funds.
- The process for changing the pension deal should be clear and not cumbersome.

This chapter sets the stage for a review of pension fund structure and investment policy in the following two chapters. It also lays the groundwork for the analysis in Chapters 6 to 13 of the seven public sector pension funds listed in our terms of reference.

[16] Part of an actuarial surplus may result from deliberate prefunding of contributions by the employer. We consider this to be part of the employer's share of the actuarial surplus. Another part of an actuarial surplus may result from over-contributions by employers and/or employees, due to conservative actuarial assumptions.

CHAPTER 4

PENSION FUND STRUCTURE

SYNOPSIS

The pension deal has implications for who determines pension fund structure. To the extent practical, pension funds should be established so that they are clearly separated from the employer/plan sponsor and plan members. The Government should not further centralize the public sector pension funds over which it has control. However, some smaller funds should be encouraged to pool their assets with larger funds for efficiency reasons. Pension fund governors should be of the highest quality and should be responsible for investment policy and for appointing internal or external investment managers.

Introduction

This chapter looks at who should determine public sector pension fund structure. It also looks at whether some or all public sector pension funds should be centralized and whether they should have internal or external investment managers.

The chapter is divided into four sections:

I. **Who determines structure**

II. **Alternative structures**

III. **Centralizing some or all funds**

IV. **Internal vs. external investment managers**

SECTION I

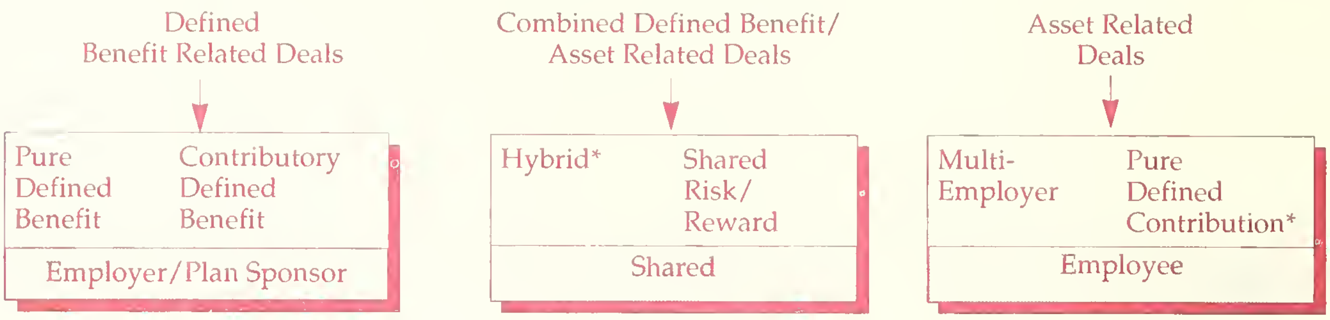
Who Determines Structure

Pension fund structure has three components:

- the organizational structure within which investment decisions are made
- the selection and appointment of pension fund governors (See Chapter 5, Section II), and
- the selection and appointment of other investment decision makers and advisors.

Figure 4.1 illustrates who should determine pension fund structure if the liability to fund an actuarial deficit or an investment risk deficit is the determining factor. See Chapter 3, Section VIII.

Who Should Determine Pension Fund Structure



* In practice, these decisions are usually made by the employer.

FIGURE 4.1

Typically, in public sector pension deals, the employer/plan sponsor determines pension fund structure. The pension fund governors are normally, but not always, responsible for making subsequent organizational structure decisions.

This raises the issue of what involvement, if any, plan members should have.

For defined benefit related deals, plan members do not have a right to be involved in organizational structure decision-making. However, they should be involved in plan management (i.e. plan administration and investment management) and, in appropriate circumstances, should be appointed as pension fund governors.

There are two reasons why we feel plan member involvement in investment management would be beneficial:

- First, because the pension fund underlies the security of the pensions promised to plan members, they have a stake in pension fund investment decisions.

- Second, improved plan member understanding and morale can be gained from their involvement in investment decision-making.

For combined defined benefit/asset related deals, decision-making should be shared.

For asset related deals, the plan members should have the major say, keeping in mind there may be practical limits to the range of options available, if for no other reason than that the employer usually assumes the administrative costs of pension plans. Unrestrained employee choice might impose unreasonable costs on the employer. Employers have a stake in the performance of an asset related pension fund to the extent that the attitude or morale of their employees is affected by poor investment performance.

Some large public sector pension plans segregate plan administration from investment management. In those plans, employees tend to play a significant role in plan administration and little or no role in investment management. In some cases, employees and their representatives play a role in both (e.g. OMERS and HOOPP).

Section 25 of the Pension Benefits Act, 1987 gives plan members the right to establish an advisory committee in cases where there is not a pension committee with at least one employee representative. Such an advisory committee can make recommendations to the plan administrator[1] respecting the administration of the pension plan and pension fund. Each class of employee covered by the pension plan is entitled to appoint at least one representative to the advisory committee.

Some employee groups believe that if employees have greater involvement in investment management they will be able to influence the kinds of investments that a fund makes. They argue that everyone makes value judgements when making investment decisions and that, in order to protect their interests and be able to express their values, employees should have at least equal representation.

Pension fund governors have a fiduciary responsibility to make investment decisions which are in the best interests of the beneficiaries of the fund and not to serve other objectives no matter how noble (See Chapter 5).

The Task Force therefore believes that it is wrong to equate employee involvement with representation of a particular point of view and the opportunity to influence investment decision-making for purposes other than the best interests of the beneficiaries of the fund.

Recommendation 4.1

Public sector employers/plan sponsors should involve plan members in plan administration and investment management and, in appropriate circumstances, should appoint plan members as pension fund governors.

Recommendation 4.2

Where the organizational structure of the pension fund in a defined benefit related pension deal is separate from the employer/plan sponsor (e.g. OMERS), a minority of the pension fund governors should be plan members.

Recommendation 4.3

Where the organizational structure of the pension fund in a defined benefit related pension deal is not separate from the employer/plan sponsor (e.g. HYDRO, HOOPP and WCB), the employer/plan sponsor or the pension fund governors should appoint a minority of plan members to its investment committee.

SECTION II

Alternative Structures

Pension funds can be established as trusts, insured investment vehicles or pension societies. The majority of pension funds in terms of assets administered are trusts.

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[1] The role of the administrator of a pension plan is described in Chapter 5.

Public sector pension funds differ from private sector pension funds in two important ways:

- first, most of the large public sector pension funds are established by legislation, and therefore are cumbersome to amend; and
- second, the assets of three of the largest public sector pension funds – the TSF, PSSF and SAF – are essentially merged with the Province's Consolidated Revenue Fund.

The following are seven different public sector pension fund structures:

- A single employer, as the plan sponsor, is responsible for both plan administration and investment management. The Ontario Hydro pension plan is an example.
- A single employer, as the plan sponsor, delegates the responsibility for plan administration and for investment management to a Pension Committee and/or a Board. The Ryerson pension plan is an example.
- A single employer, as the plan sponsor, retains responsibility for plan administration but delegates all or most of the responsibility for investment management to a Board. The York University pension plan is an example.
- A plan sponsor, who may or may not be an employer, sponsors a pension plan for many employers. The plan sponsor is responsible for both plan administration and investment management. The HOOPP plan is an example.
- A plan sponsor, who may or may not be an employer, sponsors a pension plan for many employers. The plan sponsor delegates responsibility for plan administration and investment management to a Pension Committee and/or a Board. The OMERS plan is an example.
- A plan sponsor, who may or may not be an employer, sponsors a pension plan for many employers. The sponsor delegates responsibility for plan administration to a Pension Committee or a Board but retains responsibility for investment management. The TSF and PSSF are examples.
- A plan sponsor, who may or may not be an employer, sponsors a pension plan for many employers. The sponsor retains responsibility for plan administration but delegates responsibility for investment management to a Board. The Quebec Government's public sector pension plans are an example, with the Caisse de depot et placement du Quebec being responsible for investment management.[2]

From the above it is clear that there are many ways to structure a pension fund. A plan may involve only one employer or many. The plan sponsor may or may not be an employer. Plan administration may or may not be centralized. Investment management may or may not be centralized. In addition, those responsible for plan administration may or may not be the same as those who are responsible for investment management.

[2] See Appendix I, *A Summary Description of the Caisse de depot et placement du Quebec.*

Principles Governing Pension Fund Structure Decisions

No one structure is right for all circumstances. However, regardless which pension fund structure is chosen, the Task Force believes that four principles should govern.

First, pension fund governors should be of the highest quality.

Second, the pension fund governors should understand the pension deal and their fiduciary responsibilities.[3]

Third, the pension deal should clearly set out how, to whom and for what pension fund governors are accountable.

Fourth, to the extent practical, the pension fund should be organized so that its activities are clearly separated from the employer/plan sponsor and the plan members. There are a number of considerations underlying this principle:

- We are concerned about the possibility of employers or employees causing actions to be taken by a pension fund which may be in their own interest but which are not in the best interest of the fund and its beneficiaries. For example, it has been reported that the administrators of some corporate pension funds have been directed by the employer to oppose resolutions relating to shareholder rights in other corporations. It may be in the interest of management of individual corporations to help each other defeat such resolutions. But such action may not be in the interest of the fund and its beneficiaries.
- Whether or not the principle of separation is practical for most pension funds, we believe separation is essential for funds (such as the TSF and PSSF) which are close to the Government and are therefore seen as susceptible to political direction.
- If a fund is not directly controlled by the party who bears the investment risk, a means is needed by which the tolerance to investment risk of the party bearing that risk can be communicated to the pension fund governors.

RECOMMENDATION 4.4

To the extent practical, public sector pension funds should be organized so that their activities are clearly separated from the employer and the employees.

SECTION III

Centralizing Some or All Funds

This section examines whether the Government should require, either as employer/plan sponsor or as legislator, that some or all public sector pension funds be centralized.

[3] See Chapter 5 and Appendix J, *The Law of Fiduciaries*.

As discussed in Section II, a number of public sector pension funds are already centralized. As used here, centralized has two meanings:

- First, it involves one plan and one fund for several employers. OMERS is an example.
- Second, it involves one fund and one investment management approach serving several plans and several employers. OMERS again is an example, since it manages the assets of the Colleges of Applied Arts and Technology (CAATS) and Ryerson pension plans in addition to the assets of its own plan.

The overwhelming view expressed in the briefs to the Task Force is that Ontario's public sector pension funds should not be further centralized. In fact, most briefs which comment on this issue favour the status quo.

Appropriateness of Centralizing the Investment Management of Public Sector Pension Funds

Six criteria appear relevant in assessing the appropriateness of further centralizing the investment management of public sector pension funds. These criteria are:

- Does the Government have the right to centralize the investment management of some or all public sector pension funds?
- Would centralization of investment management improve investment performance?
- Would centralization of investment management result in lower investment management costs?
- Would centralization of investment management have a beneficial or adverse impact on the capital market?
- Would economic activity be enhanced by centralization of investment management?
- Would centralization of investment management have a beneficial or adverse impact on the ability of the fund to compete on a global basis?

Right to Centralize?

Chapter 3 identifies various pension roles of the Government and concludes that, of the 86 public sector pension funds, the Government is the plan sponsor of only four funds – the TSF, PSSF, SAF and OMERS. And it is the employer/contributor for only three funds – the TSF, PSSF and SAF.

Some conclusions from this analysis are:

- Since the Government has the right as plan sponsor to determine the structure of the TSF, PSSF, SAF and OMERS, in our view it has the right to centralize the investment management of these four. In terms of size this would be significant as Figure 4.2 illustrates, involving over $23 billion or 61 per cent of the total assets.

Assets Which the Government, as Plan Sponsor, Could Place Under Centralized Investment Management

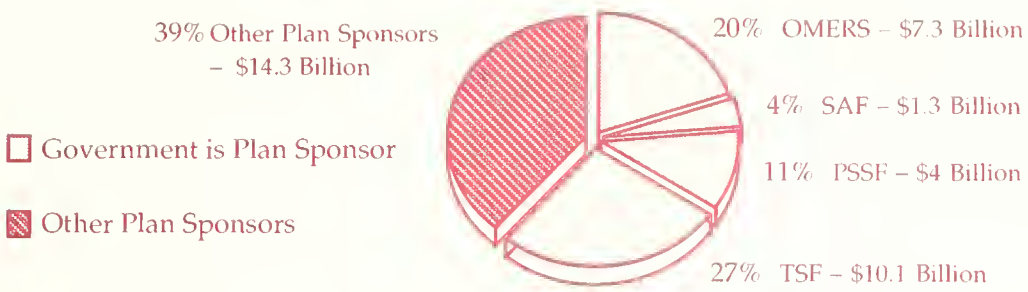

FIGURE 4.2

- Centralizing the investment management of the TSF, PSSF, SAF and OMERS would likely result in a segregated fund structure similar to the Caisse de depot et placement du Quebec. This structure probably would be appropriate because the liabilities of the funds are different.
- Centralizing the investment management of 86 public sector pension funds would require the Government to act in a role other than as a plan sponsor. In so doing it would be acting contrary to the spirit of the Pension Benefits Act, 1987, in which the Government has bound itself to act by the same rules as private sector pension funds.

Investment Performance

Chapter 1 illustrates that size is not a major factor in the investment performance of a pension fund. As such there is little to be gained from a performance point of view by centralizing large public sector pension funds for investment management purposes.

Lower Investment Management Costs

The investment management costs of most large funds with internal investment management, as a ratio of expense to assets, is approximately 0.007. This ratio is essentially the same for a very large fund such as the Caisse de depot et placement du Quebec or smaller, but still large funds such as HYDRO, HOOPP and OMERS.

Funds with external investment managers can have investment management costs of three to four times higher (see Chapter 15, Figure 15.3).

The investment management costs of funds of less than $25 million might be lower if their assets were part of a larger fund with internal investment management.[4]

There are 42 public sector pension funds with assets of $25 million or less.[5] These 42 funds cover some 4,000 employees and have assets of about $150 million at

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[4] See *Pension Fund Structure*, Research Report #2, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987), pages 70-71.

[5] There are an additional 13 public sector pension funds with assets of $25 million or less. However, these funds purchase annuities on an ongoing basis and are not included in our analysis.

December 31, 1986. They range in size from as low as $12,000 to as high as $23 million, and cover as few as one employee and as many as 500 employees.

The majority of these funds are now managed by insurance and trust companies, frequently in pooled arrangements with other small funds. We estimate that these funds could save somewhere between $300,000 and $450,000 a year in total management costs if their assets were pooled with a large fund. For the smaller of these funds, the annual savings would be very small. For the larger of these funds, the annual savings could reach $69,000.[6] Even though these savings are relatively small, we believe that it would be desirable to enable small funds to pool their assets, if they so choose, with a large fund.

Impact on the Capital Market

With few exceptions, the general view is that a large centralized fund would have an adverse impact on the capital market in that it would be so large as to influence the behaviour of the market. There would also be the perception that the Government was directing the fund to make certain kinds of investments. (See Chapter 5).

In addition, it is felt that:

- As a fund becomes bigger, any investment errors tend to be large. In a decentralized structure, this risk is much smaller.
- There is the potential for political interference in the kinds of investments made by a large centralized fund.
- Because of its size, a large centralized fund could unduly affect the Canadian capital market.

Economic Activity

Large funds which have internal investment management tend to have a more diversified portfolio than smaller funds which are managed by external investment managers. Diversified, as used here, includes such non-traditional investments as real estate, mortgages, term lending and venture capital.

Centralizing smaller funds might result in a wider range of investments being purchased, including more non-traditional investments, and in this way economic activity could well be enhanced. See Chapter 5.

Impact in Global Markets?

With financial deregulation, the internationalization of financial markets and the move to freer trade with the United States, some believe that the larger a pension fund is, the better it will be able to compete in this environment. Others are of the opinion that size will not make any difference and, indeed, could be a hindrance.

Quite apart from the inhibiting effect of the 10 per cent foreign property limitation contained in the Income Tax Act (see Chapter 5), and the reasons mentioned above, the financial community generally believes that a large centralized fund (which could have assets of up to $37 billion, depending how many funds were centralized) would not help Ontario to be a greater factor in the global economy. They believe

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[6]*Pension Fund Structure*, Research Report #2, pages 68-69, and Task Force data base.

that deregulation of Canada's financial institutions will prove to be the right kind of incentive for the private sector to organize to meet the global challenge.

We note that the TSF, OMERS and PSSF are themselves very large funds, with significant potential economic impact. However, we were not able to form an opinion as to whether an even larger, centralized fund would be a help or a hindrance to Ontario's international competitiveness.

Conclusion

In addition to the above criteria, Figure 4.3 sets out pros and cons of centralized versus decentralized funds.

Pros and Cons of Centralizing vs Decentralizing all Public Sector Pension Funds

	Centralized	Decentralized
PROS	• Lower costs • More direct control over investment program • Simplifies administration • The fund can "acquire" more people and resources	• Impact on capital markets is reduced • Less open to political influence • Power is dispersed • Reduces size problem • Pension investment divisions can be be kept small
CONS	• Possible negative impact on capital markets/investors • May be vulnerable to political influence • Difficult to assemble/keep best skills in all areas • Concentration of power: "Power corrupts" • Conflict of interest risk rises with size • Impact of errors can be significant • Size can affect management style and performance • Restricts choices of investment philosophy • Less flexible in making changes	• Higher costs • Less control over investment program • Duplication of policy makers, managers, securities

FIGURE 4.3

After weighing these pros and cons, and considering the performance of Ontario's public sector pension funds relative to the Caisse de depot et placement du Quebec and to private sector pension funds, the Task Force is persuaded that there is no merit in further centralizing Ontario's large public sector pension funds.

Recommendation 4.5

The Government should not further centralize Ontario's public sector pension funds. The existing large funds should continue to operate as separate and independent funds.

Recommendation 4.6

The Government should encourage smaller public sector pension funds to pool their assets for investment purposes with a larger public sector pension fund so that they can benefit from lower investment management costs and potentially more diversified investment opportunities.

As well, as explained in Chapter 5, we are not persuaded that pension funds should be vehicles for economic enhancement over and above that which results from the ordinary course of their investing. While size is a factor in the range of investments a fund makes and therefore influences economic activity, we believe that the disadvantages of a large centralized fund outweigh the advantages.

SECTION IV

Internal vs External Investment Managers

This section discusses a number of factors relative to the decision to have internal or external investment managers, including:

- Responsibility for investment management
- Size of assets managed
- Relative performance of external and internal investment managers
- Compensation of internal investment managers

It also examines the extent to which public sector pension funds have internal or external investment managers or both, and who should make investment management decisions.

Responsibility for Investment Management

Investment management has two parts: investment policy and investment implementation.

Pension fund governors are responsible for establishing a fund's investment policy. While they may rely to some extent on outside advisors, except for smaller funds, they do not normally delegate this responsibility to external investment managers.

Investment implementation decisions are made within the context of the fund's investment policy. Normally, pension fund governors delegate these decisions to investment managers, internal, external or both.

Size of Assets Managed

Figure 4.4 shows the asset size of Ontario's 86 public sector pension funds.

Public Sector Pension Funds by Asset Size as of December 31, 1986

	Less Than $ 1 Million	$ 1 Million to $ 10 Million	$ 10 Million to $ 100 Million	$ 100 Million to $ 1 Billion	More Than $ 1 Billion
Defined Benefit					
• Funds	2	9	17	15	6
• Assets ($ million)	1.3	38.1	623.3	4,764.4	29,716.7
Defined Contribution					
• Funds	19	5	1	1	—
• Assets ($ million)	5.0	12.3	81.1	191.7	—
Combined					
• Funds	1	—	6	4	—
• Assets ($ million)	0.1	—	254.3	1,339.9	—
Total					
• Funds	22	14	24	20	6
• Assets ($ million)	6.4	50.4	967.7	6,296.0	29,716.7

FIGURE 4.4

Six funds with assets of more than $1 billion have combined assets of $29.7 billion or 80 per cent of the total.

Twenty funds with assets between $100 million and $1 billion have combined assets of $6.3 billion or 17 per cent of the total.

Twenty-four funds with assets between $10 million and $100 million have combined assets of almost $1.0 billion or 3 per cent of the total.

Fourteen funds with assets of between $1 million and $10 million have combined assets of $50 million or less than 1 per cent of the total.

Twenty-two funds with assets of less than $1 million have combined assets of $6.4 million or less than 1 per cent of the total.

Relative Performance of External and Internal Investment Managers

Figure 4.5 shows how the 86 public sector pension funds are managed.

Internal and External Investment Management by Fund Size

Fund	Internal Management	External Management
More than $ 1 Billion	6	—
$ 250 Million to $ 1 Billion	1	10
$ 100 Million to $ 250 Million	3	10
Less than $ 100 Million	—	56
Total	**10**	**76**

FIGURE 4.5

Ten funds are managed internally. These include the six largest funds, each with over $1 billion in assets, and four funds, each with assets between $160 million and $1 billion.[7]

The remaining 76 funds are managed externally by professional investment managers, including life insurance and trust companies.

There is no conclusive evidence that internally managed funds investing through the capital market have performed worse or better than externally managed funds or the 500 Canadian funds measured by Pension Finance Associates (now SEI Financial Services Ltd.) [8]

Figure 4.6 sets out the pros and cons of internal vs. external investment managers.

Pros and Cons of Internal vs. External Investment Management

	Internal	External
PROS	• more likely to invest in non-traditional asset classes • lower costs (this depends on size) • more direct control over investment program	• access to wider range of investment skills • opportunity to diversify by skill/style • delegation/accountability is clearer • more flexible in making changes
CONS	• accountability is sometimes blurred	• administration and monitoring is more complex

FIGURE 4.6

[7] Included are the TSF, PSSF and SAF. Small portions of OMERS and HOOPP are managed externally.

[8] See Appendix D, *Capital Market Returns, Public Sector Pension Funds and Asset Mix Policy.*

Because many variables go into the decision to have internal or external investment managers or both, no one is better placed to make that decision than a pension fund's governors. Again, the key issue for the employer/plan sponsor is to appoint the very best pension fund governors and to put in place a process to monitor their performance and hold them accountable.

Recommendation 4.7

The decision to select and appoint internal or external investment managers for public sector pension funds should rest with the pension fund governors.

Compensation of Internal Investment Managers

Good investment managers are critical to good pension fund investment returns.

While there is a perception that the best and the brightest investment managers are in the private sector, the relative performance of public sector pension funds does not bear this out.

There is a danger though that public sector pension funds will not be able to compete for good investment managers in the future because salary scales in the public sector are tied to civil service pay scales. Given the importance of good investment managers, it would be false economy to tie their compensation too closely to civil service scales. Indeed, there could be merit in introducing some form of performance-based compensation for internal managers of public sector pension funds.

Recommendation 4.8

Public sector pension funds should review their compensation policies for their internal investment managers with a view to ensuring that they are in line with the compensation policies for internal investment managers of private sector pension funds.

Conclusions

This chapter assessed who determines public sector pension fund structure, and employees' role in that process. It also assessed whether public sector pension funds should be further centralized and whether they should have internal or external investment managers.

In general, the Task Force sees no compelling reason why Ontario's public sector pension funds should be further centralized. There is a good case for encouraging some smaller funds to pool their assets with a larger public sector pension fund.

CHAPTER 5

INVESTMENT POLICY

SYNOPSIS

Investment policy for a public sector pension fund should be determined by the pension fund's governors. Public sector pension funds should invest in market investments. Economic enhancement is best achieved through the capital markets. Public sector pension funds should not make investments which sacrifice investment return for other objectives. The foreign property limit in the Income Tax Act (Canada) should be increased above 10 per cent.

Introduction

Investment policy reflects the level of risk pension fund governors are prepared to assume and is most often expressed as an asset mix policy or a desired investment return. No one investment policy suits all investors. Each investor has his own investment return objectives and tolerance for risk.

This Chapter discusses "in whose interest" pension fund investments are made and whether pension fund assets should be invested in non-market government debt or used to achieve a variety of non-financial objectives.

The chapter is divided into six sections:

I. **Pension fund investment – in whose interest?**

II. **The legal framework for investment policy**

III. **Accountability**

IV. **Market investments vs. non-market government debt**

V. **Investment policy**

VI. **Global investing**

SECTION I

Pension Fund Investment – In Whose Interest?

In Chapter 3, we identified three types of pension deals and discussed their implications for ownership of a surplus (deficit). Based on that analysis, we believe that investment decisionmaking can be divided into two parts:

- investment in essentially risk-free assets
- investment in assets which have risk.

We concluded that the investment return derived from taking a level of risk above the risk-free rate should go to the party or parties who bear the investment risk.

Many plan members believe that they are the sole beneficiaries of a pension fund and the only ones who have an interest in the fund's performance. In our view, depending on the type of deal, both plan members and the employer/plan sponsor may be beneficiaries of a pension fund and have an interest in the fund's investment performance.

The plan members have an interest in the fund's investment performance to the extent that:

- the fund has enough assets to pay the pension benefits promised
- the ongoing contributions of plan members are affected by an investment risk surplus (deficit), and
- the pension benefits can be enhanced as a result of an investment risk surplus.

The employer/plan sponsor has an interest in the fund's investment performance to the extent that:

- the fund has sufficient assets to pay the pension benefits promised
- his ongoing contributions are affected by a surplus (deficit)
- he chooses to use an investment risk surplus as a source of money to pay for improvements in pension benefits without affecting his cash flow
- he may wish to build up an investment risk surplus as a contingency fund against future pension cost increases or low investment returns, and
- he is entitled to withdraw a surplus in an ongoing plan or on termination.

Figure 5.1 classifies Ontario's 86 public sector pension plans by the kind of pension deal. The objective is to determine, for each of the three types of pension deals, in whose interest the investment risk decisions are made.

Kinds of Ontario Public Sector Pension Deals and In Whose Interest Investment Risk Decisions Are Made

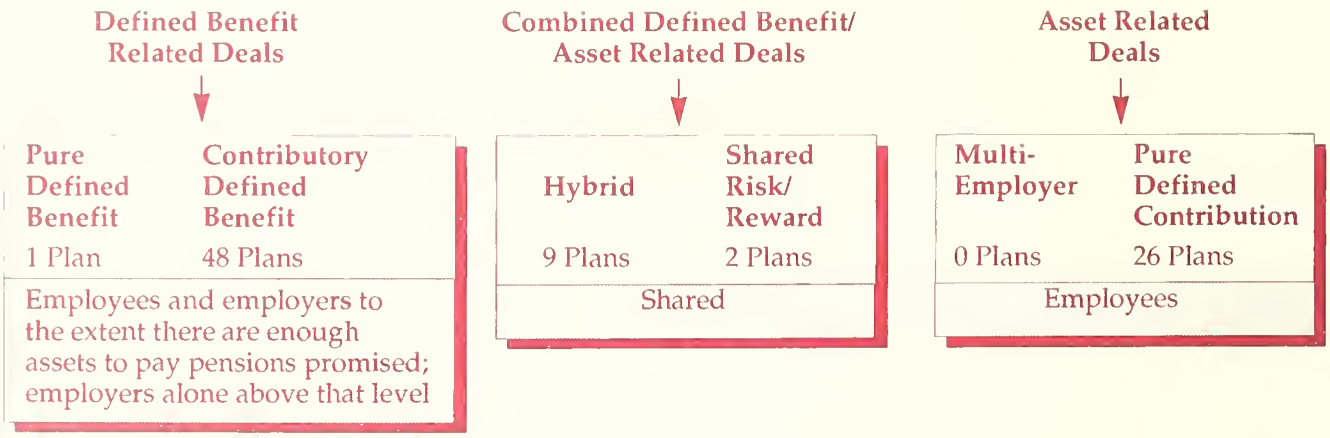

FIGURE 5.1

For the 26 asset related deals, fund assets are being invested solely in the interest of plan members, although the employer will have an interest (as employer) in the fund's ability to provide adequate pension benefits.

For the 11 combined defined benefit/asset related deals, fund assets are being invested in the joint interest of the employer/plan sponsor and the plan members. The extent of each party's interest is governed by the particular pension deal.

For the 49 defined benefit related deals, the answer is more complicated and depends upon the particular pension deal and the investment policy being pursued. In all cases, fund assets are being invested to ensure that the pensions promised can be paid. To this extent, they are being invested in the interests of both the employer/plan sponsor (to satisfy his liability to provide the pensions promised) and the plan members (to ensure that pensions promised can be paid). If the employer/plan sponsor decides to incur additional investment risk above the risk free rate of return, any resulting investment risk surplus (deficit) accrues to him.

SECTION II

The Legal Framework for Investment Policy

At common law, pension fund governors[1] are fiduciaries and, as such, have a duty of skill and care in the discharge of their responsibilities.

This duty requires them to invest fund assets in the same manner as a prudent person of business would invest them in the circumstances, having in mind not only the objectives of the fund but also the fact that they are investing the assets of others.

In carrying out their responsibilities, pension fund governors must put aside their own personal interests and views and exercise their powers fairly and honestly in the best interests of the beneficiaries of the fund. Since the purpose of a fund is to provide financial benefits for the beneficiaries, the best interests of the beneficiaries are normally but not always their best financial interests.[2]

Prior to the implementation of the Pension Benefits Act, 1987, the choice of fund investments by pension fund governors was essentially limited to a "legal list" of investments prescribed by the Canadian and British Insurance Companies Act.

Pension Benefits Act, 1987

The Pension Benefits Act, 1987 replaces this legal list approach to pension fund investment with a prudent person approach (which is, in essence, a statement of the

[1] A number of terms are used to refer to the person(s) who are responsible for pension fund investment management. These terms, most of which are discussed in Appendix J, *The Law of Fiduciaries*, include: trustee, fiduciary, administrator; governor, and investment policymaker. They do not have identical meanings and therefore can be confusing. The Task Force uses the term "governor" to refer to person(s) who have overall responsibility for investment decision-making and management.

[2] See Appendix J, *The Law of Fiduciaries*.

common law duty of skill and care), subject to limitations relating to diversification to be prescribed in the Regulations under the Act.[3]

Under the Act, every pension plan must have an administrator who must be one of the following: an employer/plan sponsor; a committee comprised of one or more representatives of the employer/plan sponsor and one or more representatives of the plan members; a committee composed of representatives of the plan members; an insurance company under an insured plan; or a board, agency or commission made responsible by an Act of the Legislature for the administration of the pension plan.[4]

The administrator is required to "exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person." The administrator is also required to "use in the administration of the pension plan and in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of his or her profession, business or calling, ought to possess."[5]

The Act appears to contemplate that the administrator will be responsible for both investment policy and investment implementation.[6]

The administrator of a pension plan may employ agents to carry out his/her duties but these agents are subject to the same standards.[7]

Generally, the prudent person standard will place the governors of private and public sector pension funds in Ontario on a basis similar to that of private sector pension funds in the United States under the Employee Retirement Income Security Act (ERISA).

Observations on the Prudent Person Standard

Based on the U.S. experience since ERISA was enacted in 1974, and on case law over a longer period, a few observations on the prudent person standard can be made:[8]

- Prudence as it relates to pension fund governors has meaning only in relation to the specific pension deal. Within this context, investment policy decisions (e.g. the asset mix) for a pension fund are made in light of several considerations, including:

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[3] See Appendix K, *Draft Regulations on Pension Fund Investments.*

[4] The Pension Benefits Act, 1987, Section 8.

[5] The Pension Benefits Act, 1987, Section 23.

[6] Regulations under the Pension Benefits Act, 1987 will require that an investment policy statement be in place for each pension fund. Implementation of investment policy is through an investment strategy leading to the selection of specific investments. Appendix L, *Prudence and Pension Fund Investment Management,* reviews the different prudence considerations between deciding investment policy and investment implementation.

[7] The Pension Benefits Act, 1987, Sections 23 and 63.

[8] See Appendix L, *Prudence and Pension Fund Investment Management.*

- an understanding of the risk tolerances of those who bear the risk of bad investment performance (e.g. the financial strength of the funding organization in a defined benefit plan)
- the characteristics of the pension plan (e.g. the relative age of the plan members and the number of retirees)
- the level of funding relative to pension liabilities.

In light of the foregoing, the pension fund governors must understand the pension deal behind the pension fund.

- There is a strong argument that the prudent person standard applies to the entire portfolio of a fund and not just to specific investments. Therefore, the relative riskiness of a specific investment or investment course of action does not necessarily determine whether it is prudent.
- On the other hand, a specific investment could be imprudent even if it does not make the overall portfolio imprudent. Indeed the draft investment regulations under the Pension Benefits Act, 1987[9] propose specific percentage limits on certain types of investments, such as resource and real estate investments. Moreover, it is clear from the draft regulations that any investment which sacrifices investment return for other objectives (i.e. a concessionary investment) would not be prudent.
- An asset portfolio containing investments which offer attractive rates of return to offset potentially higher risk, such as real estate and venture capital, can be prudent.[10] Even if such investments individually do entail higher risk, provided that the real estate and venture capital portfolios themselves are diversified, their risk level may be no higher than the risk level for the fund as a whole. Further, if specialized portfolios have higher risk levels, the overall level of risk in the fund can be kept stable through purchase of lower risk assets.
- A prudently invested portfolio would be diversified among various types of assets such as stocks, bonds, mortgages and less traditional investments, such as real estate and venture capital.
- There is always a trade-off between risk and rate of return. This can be seen as a choice within a range of investment policies between high rate of return (and high risk) at one extreme, and low rate of return (but low risk) at the other extreme. Different parties will have different abilities to accept risk (i.e. different risk tolerances) and therefore there will be different investment risk policies. A prudent investment policy always seeks to maximize rate of return at a given level of risk.
- Monthly or quarterly performance measures probably cover too brief a period for properly assessing the prudence of an investment policy. Investment policy is normally directed at longer periods.

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[9] The draft regulations are reproduced in Appendix K, *Draft Regulations on Pension Fund Investments.*

[10] *Venture Investing and Prudence,* Research Report #6, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987).

- A key criterion in testing the prudence of an investment policy would be whether an appropriate decision-making process had been followed.

While the Pension Benefits Act, 1987 has not yet been implemented, let alone been tested in the courts, these observations provide a starting point for developing an investment policy.[11]

The overall conclusion that we draw from the new prudent person standard is that a wide range of trade-offs exists between risk and rate of return. This range can extend from risk immunization,[12] to maximizing rate of return, and, at the same time, seeking economic or social objectives.[13]

SECTION III

Accountability

Pension fund governors are accountable to the employer/plan sponsor and to plan members among others.[14] In the public sector, the employer/plan sponsor is the agent for the taxpayer.

Figure 5.2 illustrates the relationship among accountability, fiduciary responsibility and prudence from a variety of perspectives.

In order for pension fund governors to be held accountable, information on their performance should be provided. The Pension Benefits Act, 1987 and its regulations identify certain information that pension fund governors must provide, including an investment policy statement and an auditor's report.

[11] The Pension Benefits Act, 1987, has been approved by the Legislature but has not yet taken effect. Most of its provisions are expected to become effective January 1, 1988 but various phase-in periods are provided.

[12] Risk immunization means selecting an investment policy which seeks to reduce investment risk (concurrently accepting a lower rate of return) yet continuing to meet the pension obligations incurred.

[13] See Section V of this chapter for a discussion of economic enhancement and social investing.

[14] We include in the term "plan members" three groups: present employees who participate in the pension plan ("active plan members"); former employees who have a deferred entitlement to a pension; and retired employees (and their beneficiaries) who are now receiving pensions.

Relationship Among Accountability, Fiduciary Responsibility and Prudence

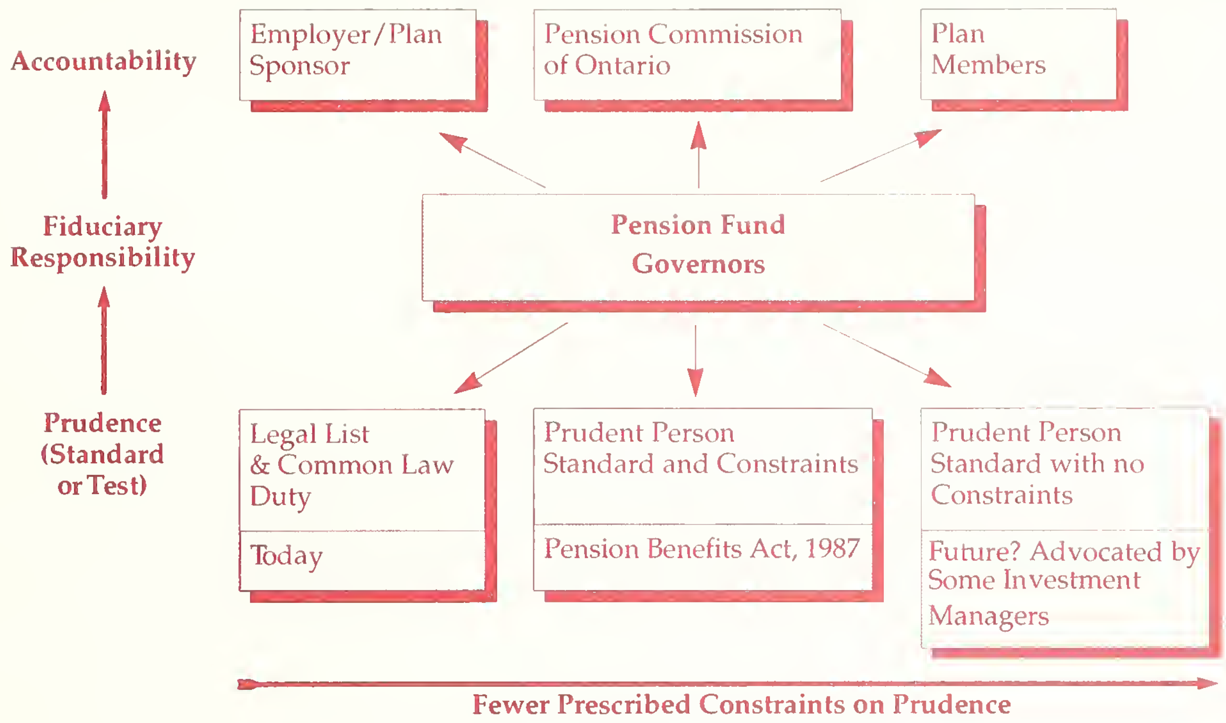

FIGURE 5.2

In the view of the Task Force, the governors of Ontario's public sector pension funds should make available to plan members and, through politically accountable bodies or other means, to the taxpayer, full information about the fund. Several of the larger funds already provide information of this type. OMERS is a good example.[15]

Illustrations of the information which might be provided (probably in summary form) are the following:

- statement of investment policy
- investment performance in relation to investment policy
- assets held by the fund
- the composition and roles of decision-making and advisory bodies, and external investment managers.

The Task Force is aware of efforts in the United States to develop a common reporting format for public sector pension funds. While this has not progressed to the stage that it could be adopted generally, the Task Force encourages Ontario public sector pension funds to develop an appropriate reporting format with a degree of consistency across funds.

Recommendation 5.1

Public sector pension fund sponsors should ensure that a formal process for holding pension fund governors accountable is in place.

[15] See Appendix M, *Reporting on Public Sector Pension Funds.*

Recommendation 5.2

As an instrument of accountability, public sector pension fund governors should provide full information about the fund annually to plan members, and should make this information available publicly for the benefit of the taxpayer.

SECTION IV

Market Investments vs. Non–Market Government Debt[16]

This section assesses whether public sector pension funds should continue to invest in non-market government debt.

All pension funds, except the TSF, PSSF, SAF and OMERS,[17] must invest in market investments.

The Legislature has decided that the TSF should invest in 20 to 25 year non-market government debentures earning an interest rate calculated according to a formula. The Legislature has decided that the PSSF and SAF should be held in the Provincial accounts for the term and at the interest rate set by the Lieutenant Governor in Council. Since 1979, OMERS has invested all contributions, investment earnings and maturing non-market government debt in market investments. It continues to hold $1.3 billion in non-market government debt issued before 1979.[18]

In total, approximately $16.7 billion, or 45 per cent of Ontario's public sector pension fund assets (at market value), was invested in non-market government debt as of December 31, 1986, all of it from the TSF, PSSF, SAF and OMERS. See Figure 5.3.

When the Legislature determined that the assets of the TSF, PSSF and SAF should be invested in non-market government debt, it also implicitly specified the asset mix for each of these funds. That is, it restricted these funds to an undiversified portfolio, composed of 100 per cent illiquid, non-market, fixed income obligations.

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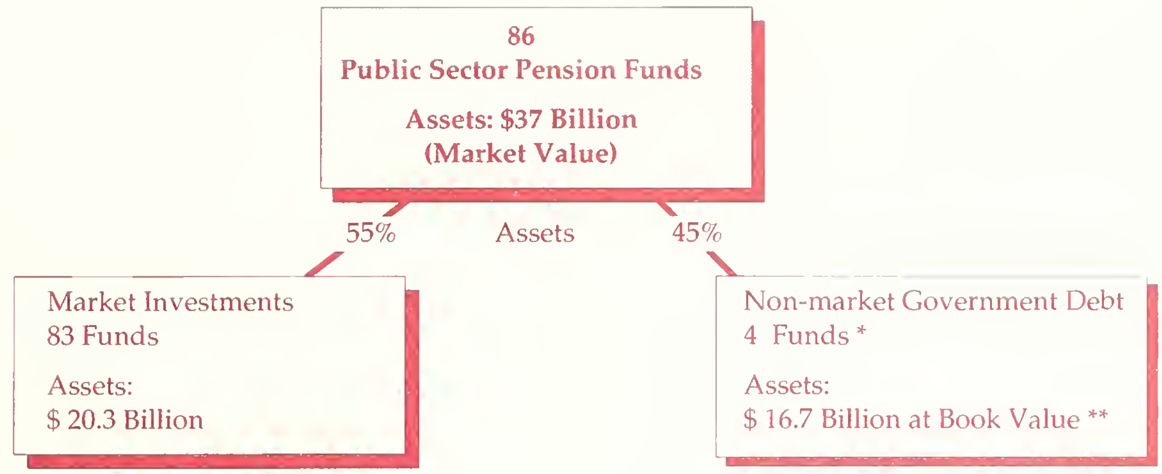
16 See *Market vs Non-Market Investments*, Research Report #4, and *Public Sector Pension Funds and the Capital Markets*, Research Report #5, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987). These two research reports provide a detailed analysis of the likely impact on capital markets and on the Province if the TSF, PSSF and SAF are invested in marketable securities.

17 Since 1979, OMERS has invested exclusively in market investments.

18 OMERS invests the pension funds of the Colleges of Applied Arts and Technology (CAATS) and Ryerson and some of the non-market government debt held by OMERS should be credited to those funds. The exact proportions are difficult to determine but are approximately as follows: 89% OMERS, 10% CAATS and 1% Ryerson.

Ontario's Public Sector Pension Fund Investment in Market Investments and Non-market Government Debt

December 31, 1986



* Includes the remaining non-market government debt of OMERS.
** Imputed market value is $18.7 billion.

FIGURE 5.3

Appropriateness of Restrictions on the TSF, PSSF and SAF

Seven criteria appear relevant in assessing the appropriateness of the requirement that the assets of the TSF, PSSF and SAF be invested in non-market government debt. These criteria are:

- Does the decision to invest some public sector pension fund assets in non-market government debt establish different rules for the Government than those which apply to other public sector employers and to private sector employers?
- Are the terms of the non-market government debt determined by the discipline and competition of the market place?
- Does the taxpayer benefit from the decision to invest in non-market government debt?
- Is a plan member's benefit security affected by the decision to invest in non-market government debt?
- Can the capital market absorb a large additional flow of assets without adverse effects?
- Would there be an adverse impact on the Province's accounts of investing the assets of the TSF, PSSF and SAF in the capital market?
- Would there be increased risk as a result of investing in market investments?

Same Rules

Under the Pension Benefits Act, 1987, the Government, as employer/plan sponsor, is required to abide by the same rules as private sector employers. The fact that some public sector pension funds invest in non-market government debt is at odds with this principle.[19]

Market Discipline

Although there is an indirect market influence on the interest rate payable by the Province on monies borrowed from public sector pension funds, the market place does not directly establish the term or the interest rate. The Task Force believes that it should.

Benefit to Taxpayer

Two considerations must be weighed to determine whether the taxpayer benefits from the decision to invest in non-market government debt: the cost to the employer/plan sponsor of providing the pension benefit, and the Province's relative cost of borrowing.

Research conducted for the Task Force indicates that, for the period 1976 to 1985, a diversified portfolio of market investments could have earned, on average, a rate of return as much as 2 per cent per year higher than that earned by the TSF and PSSF with their government debt portfolios.[20] A higher rate of return would have reduced the unfunded liability payments made by the Province during that period. If a higher rate of return could be achieved by the TSF and PSSF through market investments, the taxpayer could benefit.

With respect to the Province's cost of borrowing, there is a view (at least among some plan members) that the interest rate paid by the Province to the pension funds for non-market government debt is lower than market rates. This view is not shared by the OFL.[21]

Our research indicates not only that the Province is paying market-related rates to the pension funds, but that if the Province could reduce its borrowing from the TSF, PSSF and SAF, it would have greater borrowing flexibility and thereby the opportunity to reduce its borrowing costs.[22]

In short, the taxpayer (as employer/contributor) could benefit from a higher investment return from a diversified market portfolio in the TSF, PSSF and SAF, while paying similar or lower average costs of borrowing in the capital market compared to the present non-market borrowing from these funds. Such potential gains by the taxpayer would have no adverse effect on pension benefits.

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[19] The Pension Benefits Act, 1987 permits pension funds to invest in government or government guaranteed securities, with no limits. However, this provision does not address the non-market nature of the current investments.

[20] *Market vs Non-Market Investments*, Research Report #4, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987), page 31.

[21] OFL Brief, page 22.

[22] *Market vs Non-Market Investments*, Research Report #4, (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987), pages 25-28.

Benefit Security

Assuming that future governments and taxpayers would not renege on the pension promise, a plan member's benefit security is not likely to be affected by investments in non-market government debt.

However, some plan members believe that their pension benefits would be more secure if "their" fund were segregated from the Provincial accounts and invested in a diversified portfolio.

Certainly, a diversified portfolio would provide plan members with market assets to back their pensions. These assets would be independent of the willingness of future governments or taxpayers to pay the cost of their pensions and may be reassuring to present and future plan members.

Capital Market Impact

Task Force research indicates that investing the TSF, PSSF and SAF in market investments, if implemented gradually, would not have an adverse effect on the capital markets. The potential increase in pension fund cash flow in the capital markets would be about $2.3 billion per year (or $3.2 billion including CPP funds). Even assuming that half the increased cash flow is invested in equities, this amount would not have a large impact on the Canadian equity market with present total assets of about $350 billion.[23] There could be some initial increase in equity prices and a long-term positive economic impact.

If, in addition to this shift, a growing proportion of RRSP funds is invested in equities, the result could be upward pressure on equity prices.[24] However, we anticipate that such upward pressure could induce other investors to withdraw from the equity market and seek other investment opportunities, thereby lessening the net impact.

One concern which has been raised with the Task Force is the increased proportion of the country's total savings[25] which are held in pension or retirement savings funds. There are strongly held views that this situation removes control of large parts of the savings pool from the individuals whose savings are being invested and concentrates economic power in fewer hands. The Task Force has been unable to assess the validity of this concern.[26] However, we believe such concerns underscore the need for high quality pension fund governors, for clear processes of accountability and for timely and understandable reporting to plan members and the public.

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[23] See *Public Sector Pension Funds and the Capital Markets,* Research Report #5.

[24] *An assessment of the potential impact of mandated inflation protection in employment pension plans on Canada's capital markets.* A draft paper for the Ontario Task Force on Inflation Protection for Employment Pension Plans, by Keith P. Ambachtsheer, August 1987.

[25] As an example, average market value assets per Ontario public sector member, including beneficiaries, amounted to approximately $57,000 at the end of 1986, an increase of 15 per cent over year-end 1985.

[26] The Task Force obtained information on share holdings of OMERS, HOOPP and HYDRO which represented more than 10 per cent of the outstanding common shares of medium to large Canadian corporations. Neither HOOPP nor HYDRO have any holdings exceeding 10 per cent. OMERS has four holdings in excess of 10 per cent but less than 15 per cent.

Provincial Financial Presentation

There are three deficit measures used to characterize Ontario's financial position:

- The budgetary deficit, which measures the difference between current taxation and related revenues, and current operating and capital expenditures.
- The operating deficit, which measures the difference between current taxation and related revenues and operating (but not capital) expenditures.
- The net cash requirements, which reflect the financing (borrowing) requirements of the Province. This measure is less than the budgetary deficit since it reflects the Province's net cash requirements after taking the net cash flow (or "borrowing") from the PSSF, SAF, Province of Ontario Savings Offices and other trust accounts and after its net loan repayments.

The most commonly cited measure of Ontario's deficit is net cash requirements, (NCR). The most commonly cited measure of the federal deficit is the budgetary deficit.

If all funds flowing to the Province through the PSSF and SAF were instead invested through the capital market, there would be no effect on either the budgetary deficit or the operating deficit. However, the net cash requirements would increase by about $800 million (1987/88 data). The same result would occur if the PSSF and SAF were invested in non-market securities, as is done with the TSF.

Although such a change in financial presentation would not alter the Province's underlying financial position as measured by the budgetary deficit or the operating deficit, we recognize that it might be perceived by some to do so as a result of the impact on the net cash requirements. Consequently, a very clear explanation of the change would be essential. A restatement of previous years' performance on a comparable basis would assist public understanding.

The financial community is generally aware of the Province's underlying financial performance and a change in financial presentation would have minimal impact on its perception of the Province's finances.

Risk

Five types of risk were examined to assess whether a shift from non-market to market investments would involve greater or lesser risk.[27] These risks are:

- default risk
- market volatility risk
- inflation risk
- liquity risk, and
- independent return risk.

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[27] *Market vs. Non-Market Investment,*, Research Report #4 (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987), pages 15-18.

As Figure 5.4 illustrates, all categories of risk would be either neutral or lower as a result of a shift to market investments with the exception of independent return risk and default risk. The overall conclusion of our research is that there is scope for the funds involved to take on more risk because the independent return risk is presently zero and all other risk elements (again with the possible exception of default risk) would be neutral or show declining risk with a shift to market investments.

Summary of Relative Risk

Type of Risk	Relative Risk: Non-Market Investments	Relative Risk: Market Investments
Default Risk	Same or lower	Same or higher
Market volatility risk	Higher	Lower
Inflation risk	Higher	Lower
Liquidity risk	Higher	Lower
Independent return risk	Zero	Higher

FIGURE 5.4

Conclusion

This review reveals potential advantages and no major disadvantages or obstacles to the investment of the TSF, PSSF and SAF in market investments.

Recommendation 5.3

As a matter of principle, public sector pension funds should invest only in market investments.

Recommendation 5.4

Subject to appropriate phasing-in periods for both cash flow and existing non-market government debt, the TSF, PSSF and SAF should invest only in market investments.

We anticipate that, as has been the case with OMERS, existing non-market government debt held by the TSF, PSSF and SAF would be held until maturity, at which time it would be invested through the capital markets.

SECTION V

Investment Policy

This section discusses pension fund investment policy under the following headings:

- Investment policy goals
- Conventional portfolio management vs. strategic investing
- Economic enhancement
- Traditional and non-traditional investments
- Social investing

Investment Policy Goals

Generally, a pension fund will pursue an investment policy which will have a financial rate of return goal that reflects the degree of risk which is seen to be the most appropriate for the fund. No particular level of risk is right for all funds – the choice will depend on the plan profile (i.e. plan assets and liabilities, contribution rates and cash flow requirements) and the risk tolerances of those in whose interest investments are made. Generally, the financial rate of return goal will fall between two risk-related poles:

- to minimize risk and accept a lower rate of return, and
- to maximize return at an acceptable level of risk.

Two supplementary investment goals are promoted by some, in addition to the financial rate of return goal:

- to supplement the financial rate of return goal with a variety of non-financial objectives, or
- to make concessionary investments in order to achieve primarily social or other objectives and only secondarily a financial rate of return. (This is contrary to the provisions of the Pension Benefits Act, 1987.)

A prudent investment policy seeks to maximize rate of return at a given level of risk.

The choice of asset mix will reflect the investment risk decision made by the pension fund governors. For example, a portfolio with a higher portion of equities than bonds would be considered to have a higher level of risk than a portfolio that had the reverse. A diversified portfolio (containing stocks, bonds and other investments) may have a lower level of risk than a portfolio containing 100 per cent bonds.

The asset mix policy decision has an overwhelming impact on the financial rate of return of a pension fund, accounting for over 87 per cent of the difference among pension funds, according to one study.[28] Other factors such as the quality of the investment managers, the quality of the particular investments within the asset mix policy, and market timing contribute the rest.

It is therefore of crucial importance that the pension fund governors select an asset mix policy which is right for the fund and the related pension deal. This reinforces the importance of selecting high quality pension fund governors.

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[28] "Active vs Passive Management: The Canadian Experience," John H. Ilkiw (Benefits Canada, April 1987).

Conventional Portfolio Management vs. Strategic Investing

Most pension funds (in Ontario, at least) are invested under the conventional portfolio management approach. The main characteristics of this approach are:

- responding to short-term market signals to buy or sell particular investments. This can result in substantial trading activity;
- diversifying investments, usually with a limited stake in any particular investment; and
- being influenced by comparative performance measurement services, which generally focus on quarterly or annual performance measures.

There is evidence, however, that some funds in Canada and elsewhere are adopting a longer-term, strategic investment approach for at least part of their equity portfolios. We are advised that the Caisse de depot et placement du Quebec manages part of its equity portfolio on this basis. On a much smaller scale, the venture capital and private placement investments of some of the large Ontario public sector pension funds also represent strategic investing. The main characteristics of this approach are:

- identifying and purchasing investments with strong long-term growth potential. Such choices are based on strategic considerations, normally of an economic/financial nature;
- holding significant equity (with voting rights) in individual investments;
- maintaining these holdings even if the short-term market situation suggests selling them, so long as the long-term potential remains strong; and
- being prepared to participate in the strategic direction of individual investments (e.g. through a nominee on the company's board of directors).

Given the long-term nature of pension liabilities, a long-term, strategic investment approach appears desirable. However, the conventional portfolio management approach has many adherents. Some of the considerations in weighing the two approaches are:

- Which one is likely to provide better investment performance?
- Are some types of pension funds better suited to one approach or the other?
- To what extent are different investment management skills required for each?
- What are the risks of each approach?

Unfortunately, a valid comparison between the two approaches would require an analysis spanning several years. Short-term performance measures of the kind now in use are of little value in assessing a long-term strategic investment approach. In the absence of such an analysis, we offer the following observations:

- Some studies of conventional portfolio management for equities have concluded that the costs of investment management (e.g. transaction costs) can often equal or exceed any additional returns over holding a passive portfolio based on the mix of stocks in the market. However, certain investment managers have consistently done better than the average.

- Large pension funds are in a better position to hold large stakes in individual companies without taking an undue risk. Moreover, a very large fund, such as the Caisse de depot, may find itself holding a large stake in a number of companies if for no other reason than that the monies it has available for investment in Canadian equities are substantial in relation to the available equity in the Canadian stock market.
- It likely will be difficult to maintain understanding and support for a strategic investment approach through adverse market conditions. Good communication is essential among investment managers, pension fund governors, employers and plan members.
- Each of the two approaches requires a distinct set of attitudes and skills, both at the Board of Governors level and at the investment management level. Finding the right people and providing clear direction are vital.
- A strategic investment approach is susceptible to influence on non-market grounds, based on political direction or personal preferences. A clear system of accountability is essential to ensure that inappropriate action is not taken.

On balance, our view is that there is no overriding reason why pension funds should not invest at least part of their portfolios in strategic investments, in addition to using conventional portfolio management for the balance of their portfolio. Indeed, this combination appears desirable, subject to the following caveats:

- given the diverse circumstances of pension funds and investment managers, there should be no blanket requirement to adopt one approach or the other
- clear lines of accountability should be in place and followed to ensure that strategic investments are made on economic/financial grounds, in the best interest of the pension fund and its beneficiaries.

Economic Enhancement

Should public sector pension funds be used for economic enhancement?

While all market investments have economic consequences, there is not universal agreement that the consequences of a particular investment are desirable or the best obtainable.

Economic enhancement means different things to different people.

Some believe that economic enhancement is best achieved through the marketplace. Others believe that better economic performance will result if the Government intervenes in the economy. In this respect, economic enhancement is as much a political as an economic concept.

An assumption often made by the advocates of intervention is that the capital markets are imperfect and do not provide funds to sectors "truly deserving." As a result, the Government has an obligation to compensate for capital market imperfections. This logic could lead to proposals that public sector pension funds should be directed to make investments which would benefit particular industries, regions or sectors of the economy. The rationale for such proposals appears to be based on the belief that public sector pension funds are tax money by another name.

Many advocates of letting the marketplace work acknowledge that capital markets are imperfect but state that they are the best means of allocation available.

The issue is: should public sector pension funds be directed by the Government to make investments which are not in the financial interest of the fund but which serve to correct the real or perceived imperfections of the capital markets? The short answer is no. Public sector pension funds should make investments which are in the best financial interest of the beneficiaries of the fund. They should not be directed to make investments which are not in the best financial interest of their beneficiaries.

In coming to this conclusion, we tested it against the following criteria:

- Would the benefit security of pension fund beneficiaries be affected if, as a result of Government direction, investments are made which subsidize taxpayers, a region of the province, an industry, or an individual?
- Would responding to Government direction conflict with the fiduciary responsibilities of the Boards of Governors of a pension fund?
- Are public sector pension assets tax money by another name and therefore subject to Government direction and control?
- Are there alternative ways for the Government to achieve its economic enhancement objectives without directing public sector pension funds to make particular kinds of investments?

Benefit Security

If the Government directs or influences a public sector pension fund to invest in particular ways and this results in the fund conferring a subsidy on someone other than the pension beneficiaries, the benefit security of plan members, in a defined benefit related deal, is unlikely to be affected. This, of course, assumes that future governments and taxpayers would not renege on the pension promise.

Conflict with Fiduciary Responsibilities

The Pension Benefits Act, 1987, establishes the prudent person test as the basis for pension fund investment decisions. If, as a result of Government direction, public sector pension fund governors make investment decisions which are not in the best interest of the fund and its beneficiaries, they would be in breach of their fiduciary responsibilities. While special legislation could permit the governors to make such investment decisions, this would not be consistent with the spirit of the Pension Benefits Act, 1987, which binds the Crown.

Are Pension Assets Tax Money?

Chapter 3 establishes that most public sector pension fund assets are derived from the contributions of both employers and employees and from investment income. In essence, a pension fund is a trust fund, the purpose of which is to provide enough assets so that the pensions promised can be paid.

In our view, once a public sector employer has contributed to a fund, and provided he has not over-contributed and there is no actuarial surplus or investment risk surplus, the assets in the fund are not tax money.

Alternative Ways

The Government can achieve its economic enhancement objectives without directing or otherwise unduly influencing the investment policies of public sector pension funds. Two of these ways include:

- the Government could provide a guarantee, such as a guaranteed mortgage for low income housing, to encourage pension funds to invest in particular securities
- the Government could borrow funds in the capital market to finance government-sponsored programs designed to enhance economic activity. Pension funds normally invest in government bonds.

Recommendation 5.5

The Government should not direct public sector pension funds to make investments which are not in the financial interest of the funds and their beneficiaries.

In the remainder of this section, we review various types of traditional and non-traditional investments and the supporting arguments for each.

Traditional and Non-Traditional Investments

Figure 5.5 illustrates the range of traditional and non-traditional investments for pension funds.

Traditional and Non-Traditional Investments

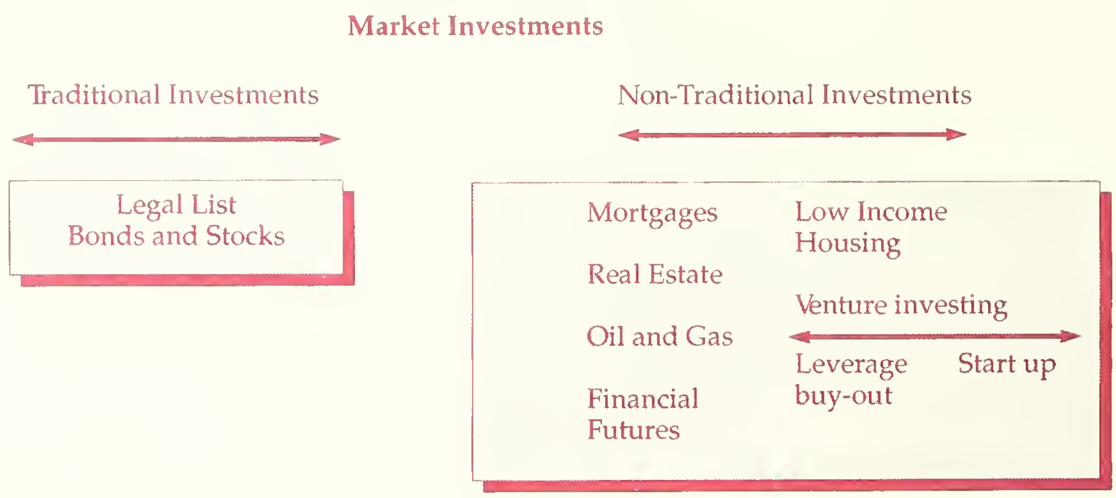

FIGURE 5.5

Legal list bonds and stocks are traditional investments. The further one moves away from these bonds and stocks, the more non-traditional the investment becomes. It is called non-traditional because the legal list approach that pension funds have had to follow up to now has largely restricted them to bonds and stocks.

Some believe that pension funds should invest in a wider range of investments than they have traditionally done. The motivation for these demands ranges from a desire to open up new sources of financing for their particular businesses or sectors, to a desire to achieve social, political or economic development objectives.

Non-traditional investing is not necessarily imprudent nor does it necessarily mean that pension fund governors are not exercising their fiduciary responsibilities.

As illustrated by Figure 5.6, some public sector funds have ventured down the non-traditional investment path.

Examples of Non-Traditional Investments by Ontario Public Sector Pension Funds in 1985

Fund	Fund Size ($ Billion)	Venture Capital	Mortgages	Real Estate
OMERS*	7.1	1.0%	17.3%	4.3%
HOOPP	3.2	0.6%	8.1%	2.6%
HYDRO	2.9	0 **	8.5%	4.6%
U of T	0.6	1.1%	4.3%	0
CARLETON	0.1	0.9%	0.1%	1.4%
O.R.F. ***	0.01	0.8%	10.5%	10.1%

* Includes assets of CAATS and Ryerson.
** Since 1985, Hydro has moved into venture capital investing.
*** Ontario Research Foundation.

FIGURE 5.6

Some reasons why public sector pension funds are increasing their non-traditional investments include:

- The rates of return on such investments have been good, indeed better than were originally thought possible, given the risk (e.g. venture investing).[29]
- There are more investment vehicles available for pension funds now than in the past. Some of them have government guarantees which insulate the investor from risk of default on that investment (e.g. mortgages with a government guarantee) or which provide interest rate incentives to ensure the investment will be competitive.
- Financial intermediaries are becoming more sophisticated and are providing pension funds with alternative places to invest their money (e.g. venture capitalists).

[29] See the Task Force Research Report #6, *Venture Investing and Prudence*, for an analysis of pension fund venture investing. A major conclusion of that report is that Ontario's public sector pension funds are increasingly providing capital for venture investing and government should not direct pension funds to make such investments.

- As pension funds become a larger factor in the marketplace, and as the Canadian stock market becomes more illiquid, some look to non-traditional investments for higher returns.
- As some pension funds have grown in size and sophistication, their investment managers have developed an expertise which allows them to seek out non-traditional investments. In short, they now feel more comfortable with them. Allied to this is the notion of the law of large numbers which in effect says that, as a fund grows, it is able to invest a significant but still small portion of its assets in areas where it would otherwise not be willing to invest.
- A sense of obligation to the community (e.g. investing in Ontario mortgages rather than the mortgages of another province, all other things being equal).

The replacement of the legal list approach with the prudent person approach in the Pension Benefits Act, 1987, should accelerate the trend to more non-traditional investments by larger funds.

Social Investing

Social investing has its roots in such concepts as:

- social responsibility – this concept promotes shareholder activism and ethical investment strategies (e.g. rejecting South African investments).
- economic democracy – this concept promotes gaining control over pension fund decision making.

Pension funds are seen as a new form of "social capital" that should be used to assist local economies and support enterprises owned by workers, consumers, government or community-based organizations.

"With the growing awareness of the size and significance of their assets, pension funds are coming to be viewed as potential remedies for such practical economic problems as scarcity of resources, foreign competition, industrial decline and technological change,"[30] one U.S pension fund expert has said.

Like economic enhancement, social investing means different things to different people. For some, it means retaining the test of market determined rates of return but applying it to non-traditional investments (e.g. venture capital, oil and gas, real estate and mortgages).

For others, it means using social criteria in addition to financial investment criteria as the basis for investing (e.g. low income housing with government guarantees).[31] In the final analysis, the investment must meet financial rate of return criteria. This approach is sometimes called "social bonus investing" and occurs when pension fund governors, confronted with a number of prudent investments that are equally desirable from the financial standpoint, choose one that provides incidental social benefits as well.

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30 Gray, Hillel, *New Directions of Pension Funds*, Washington, D.C., Investor Responsibility Research Center, 1983, P. 113

31 The OFL argues that workers have a right to have "their social values reflected in the use to which their savings are put," OFL Brief, Pages 2 and 3.

Corporate Responsibility

Corporate responsibility is a form of social investing. It involves monitoring corporate behaviour and calling it to account if it is not acting in a "socially desirable" manner. It reflects two beliefs:

- first, that the actions of some corporate managements impair shareholder rights and ignore the responsibility which corporations have to the community at large; and
- second, that an investor such as a pension fund has a responsibility both to its investment clients and to society at large to take an active rather than a passive role in the affairs of the corporation in which an investment has been made.

Some advocates of corporate responsibility also believe that it is essential that pension fund governors be able to take into account non-financial criteria when making investment decisions. Some advocates go even further and say that a way has to be found to get pension fund governors to mirror the wishes of plan members.

There are two broad options available to pension fund governors if they do not like the way a particular corporation in which they have invested is being managed.

First, they can "vote with their feet" and sell the investment. This is what many pension funds in the United States did with their investments in corporations having holdings in South Africa. The problem with this option is that, in carrying it out, it is difficult for the pension fund governors to avoid imposing losses on the fund. A fund's holdings may be so large that the price of the stock may be adversely affected as the stock is sold. As well, the fund is faced with the real problem of reinvesting the money realized on the sale.

Second, they can try to change the behaviour of the managements of the corporations, indirectly by voting their stock, or directly through meetings with management.

A more difficult and contentious issue is requiring pension fund governors to mirror the wishes of plan members. There are a number of practical problems with this suggestion. First, are the wishes of plan members consistent with the pension deal? Second, do the wishes of plan members coincide with the fiduciary responsibilities of the governors? Third, how are the wishes of plan members to be assessed and who assesses them?

These important matters do not fall within the terms of reference of the Task Force and are beyond our capacity to assess and comment on in the time available.

Nonetheless, we believe that high quality pension fund governors are sensitive to societal issues. Even so, no matter how attractive one might find the leverage provided by pension fund assets and investments to achieve political, social or ethical objectives, it is important that the basic purpose of a pension fund not be forgotten. Nor should the fiduciary responsibilities of the pension fund governors be subverted.

Concessionary Investing

For some, social investing means seeking non-financial goals even though the financial performance of a particular pension fund might be impaired. Examples include:

- investments in low income housing with no government guarantee
- exclusionary investments (e.g. no South African investments)
- investments only in unionized companies
- regional economic development investing.

This type of social investing is often called concessionary investing, since it could confer a subsidy on some individual group, business or region by accepting a lower financial rate of return than would be available through other investments, given the same level of risk.

Only the Ontario Federation of Labour (OFL) appears prepared to accept a lower financial rate of return as a consequence of social investing and only then if such investment decisions reflect the values of plan members.[32] Briefs from a number of individual public servants and others are against accepting a lower financial rate of return for funds of which they are current or future beneficiaries.

Given the objectives of social investing, it is important to advocates of social investing that there be greater access to investment decision-making by plan members and their representatives. Such access would include:

- the selection of pension fund governors
- the selection of investment managers and investment advisors
- the determination of investment policy
- the exercise of voting rights attached to pension fund stock.

The fiduciary responsibilities of pension fund governors appear not to be appreciated by some. In fact, it is of considerable concern to the Task Force that some people appear more interested in achieving their concept of a just and equitable society through pension fund investments than in the basic purpose of a pension fund.

Although an increasing number of Ontario public sector pension funds are investing in non-traditional areas, the Task Force was not able to identify any funds which have made concessionary investments.

Relationship among Traditional, Non-Traditional and Social Investing

Figure 5.7 illustrates the relationship among traditional, non-traditional and social investing. The objective is to show that these different terms are part of a spectrum.

Traditional investing is traditional only in the sense that it has been, up to now, the principal type of investment that pension funds were allowed by law to make.

As Chapter 1 shows, smaller funds tend not to invest in non-traditional

[32]Based on a meeting with the OFL and public sector unions, August 21, 1987.

investments. In addition to legal impediments, a fund's size is a factor in determining the kind and range of non-traditional investments.

At some point, however, as a pension fund moves down the spectrum from traditional to non-traditional investments, the line between economic investments and uneconomic investments could be crossed. At this point, the fund would be conferring a subsidy on an individual, group, business or region.

Pension Fund Investing: Range of Options

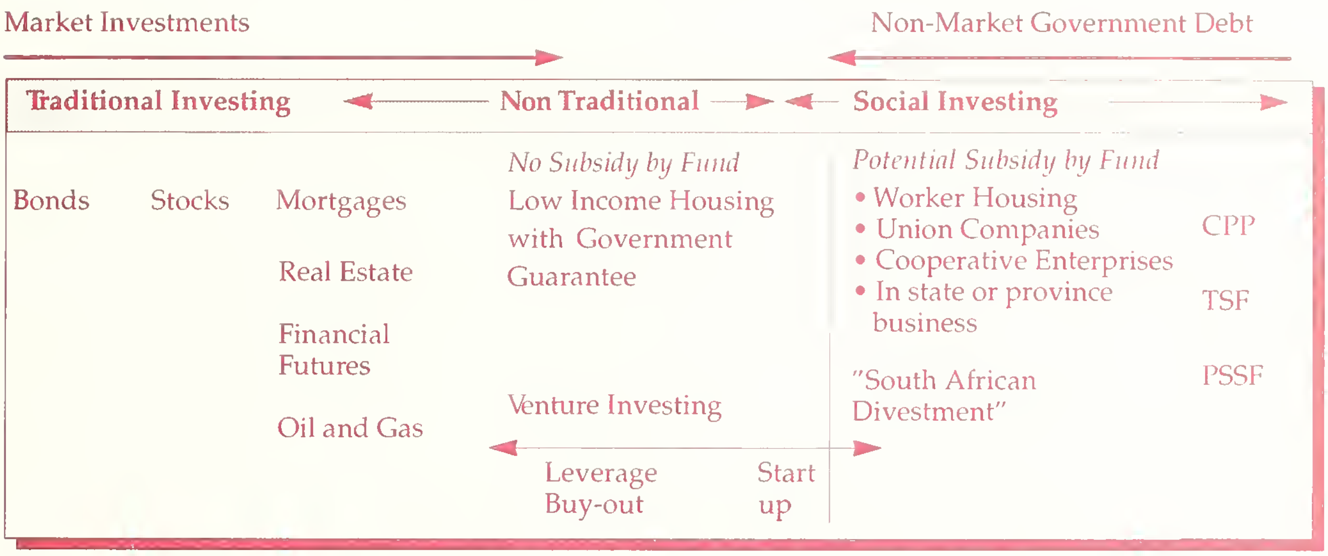

FIGURE 5.7

There is an argument for saying that the non-market government debt held by the TSF, PSSF, SAF and OMERS is a form of social investing, in that assets are not invested through the capital market but in government assets and programs.

Similarly, the investment of CPP money in non-market government debt could also be termed a form of social investing. Indeed, the OFL is of this view and considers it desirable provided the funds are "used for infrastructural investment and . . . not . . . treated simply as additions to general revenues."[33]

Experience in Other Jurisdictions

The United States experience with social investing is instructive. For example, since 1980, the U. S. Department of Labour has maintained that, for private sector pension plans under the jurisdiction of the Employee Retirement Income Security Act of 1974 (ERISA), non-financial criteria may be used in selecting between investments, but only after an evaluation of financial criteria. Public and private sector pension plans in the United States are not subject to the same rules, as they are in Ontario.

As well, the U.S. Internal Revenue Service, which determines the tax-free status of all pension funds, has ruled that other parties may benefit from a fund's investment if:

[33] OFL Brief, page 35.

- the cost of the investment does not exceed fair market value
- a fair return commensurate with prevailing rates is achieved
- sufficient liquidity to operate the plan is not sacrificed
- the safety and diversity required of a prudent person are present.

A report for the U.S. Municipal Finance Officers Association has concluded that public sector pension plans can play a role in the economic development process if the following two basic criteria are met:

- there is no sacrifice in return or assumption of increased risk at a given return; and
- economic incentive investment vehicles or financial intermediaries are provided to attract and facilitate an increased flow of public sector pension funds into selected areas.

The authors of that report caution against techniques to increase the flow of public sector pension fund money which only displace other investments and result in no net increase in total financing.[34]

Summary and Conclusions

The Government should not confuse its role as legislator/regulator with its roles as an employer/plan sponsor, contributor to the pension fund or source of funding for another employer. Nor should it place other public sector employers and pension fund governors in a position where their fiduciary responsibilities to their funds take second place to other objectives.

There should be no exceptions to the principle that future investments by public sector pension funds should be governed by the same rules as private sector pension funds.

We see no reason why public sector pension fund governors should not seek to achieve social or other objectives so long as the financial rate of return goal remains paramount and there is no concessionary investment of public sector pension funds.

If the Government wishes to use pension funds to achieve concessionary investment objectives involving a subsidy, it should provide incentives, such as government guarantees, which are available to all investors, including pension funds. The subsidy, if there is one, should be provided through government programs. Pension funds should not be expected to subsidize economic development.

Similarly, if the Government wishes to constrain or target pension fund investment, even though there may be no subsidy involved, it should make its rules applicable to all pension funds, private and public. Public sector pension funds should be no more or no less susceptible to government direction in this respect than private sector pension funds.

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[34] *Alternate Investing by State and Local Pension Funds: Concepts, Issues and Policies,* John Petersen and Catherine L. Spain, Municipal Finance Officers Association, Government Finance Research Center, Washington, D.C., December 1980.

SECTION VI

Global Investing

The Income Tax Act (Canada) imposes a one per cent monthly penalty tax if pension funds invest more than 10 per cent of their assets in foreign property.[35] This constraint on foreign investment is often referred to as the 10 per cent foreign property limit.

In 1985, 36 of 41 Ontario public sector pension funds surveyed had investments in foreign stocks. See Figure 5.8.

1985 Investment in Foreign Stocks by Ontario Public Sector Pension Funds

Total Funds Surveyed	41
Funds Investing In:	
Stocks	41
Foreign Stocks	36
Average Foreign Investment as a Per cent of Total Assets	9.4%

FIGURE 5.8

Partly because of superior performance exhibited by foreign stocks during the 1981-1985 period, Task Force data shows that those funds which invested in foreign stocks during this period experienced higher overall rates of return than those which did not.

If trusteed Canadian pension funds had been able to invest 20 per cent of their assets in foreign stocks during the period 1982 to 1986 instead of 10 per cent, it is estimated they would have earned $5 billion more than they actually did. This would have increased their 1986 assets from $150 billion to $155 billion.[36]

International trends have implications for pension funds. Some of these include:

- New technology, such as computerization and increased use of telecommunications, is fast making time zones and national borders obsolete.

- Financial institutions have become more international in their operations as investment between countries becomes more common. (It is estimated that

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[35] This rule was liberalized somewhat in the 1985 federal budget where $3 of additional foreign investment is allowed for every $1 investment in Canadian venture capital investment made after 1985.

[36] Ambachtsheer, Keith, *The Ambachtsheer Letter*, #38, Keith P. Ambachtsheer and Associates Inc., July 16, 1987.

one quarter of the total stock market value trading is concentrated in 400 companies.)

- Deregulation trends in the United States and elsewhere are placing increasing pressure on Canadian financial institutions to compete.

In addition to the internationalization of financial markets, the Canadian equity market is becoming dominated by corporate and institutional investors (e.g. pension funds, mutual funds, insurance companies). This, in theory at least, may result in less market breadth. Combined with the number of shares which are control blocks, it may well be that a pension fund or any other stockholder could have difficulty selling a large ownership position in a company without adversely affecting price.

Pension funds have to operate within this dramatically changing climate.

The OFL advises that a majority of public sector employees who are members of unions which are part of the Federation are opposed to their pension funds investing in foreign securities. The OFL is opposed to any relaxation of the 10 per cent foreign property limit.

The fact that investments in such foreign securities would have resulted in better returns to the fund, at least over the past five years, and would reduce overall risk, apparently is either not well understood or is rejected by some for other reasons.

The argument in favour of relaxing the 10 per cent foreign property limit is that by being allowed to invest more of their assets in foreign investments, Canadian pension funds would be able to:

- avoid overheating the relatively small (by international standards) Canadian equity and bond markets
- diversify their investments more and thereby reduce risk
- take advantage of potentially higher rates of return which some international markets may provide.

The arguments against are:

- Canadian pension funds should be obliged to invest most of their assets in Canada because:
  - they are tax-exempt
  - Canada needs the investment capital, particularly for smaller firms, to modernize its capital stock.
- If pension funds were allowed to invest more of their assets in foreign investments, this would have a significant, adverse impact on the value of the Canadian dollar.
- Pension funds should not take on a substantial foreign exchange risk, since pension liabilities are payable in Canadian dollars.

We believe the current 10 per cent foreign property limit contained in the Income Tax Act is too restrictive. Increasing the limit likely would result in better pension fund financial performance, thereby permitting reduced employer and employee contributions or improved pension benefits, depending on the pension deal.

That is not to say that foreign markets have always outperformed or will outperform Canadian markets. But the ability to invest abroad does allow a pension fund to take

the opportunity of earning potentially higher returns offered outside Canada without increasing its overall risk.

Hedging to insulate against currency risk has become a common practice in international trading. If investments in foreign property promise to yield a higher return after reflecting hedging costs, no additional risk is taken.

As stated earlier, the Task Force is of the view that the primary goal of pension fund investment is to provide enough assets to meet the pension plan's obligations. In that respect, the arguments relating to tax exempt-status and direction of pension assets to meet other economic or social objectives are not valid.

Recommendation 5.6

The Government should request the Federal Government to raise the foreign property limit contained in the Income Tax Act above 10 per cent.

Conclusions

The investment policy of public sector pension funds should be set by the governors of the fund in light of the pension deal and the risk tolerances of those whose interests are affected. The investment policy should not be directed by the Government. Those funds which now invest in non-market government debt should begin investing in market investments.

Economic enhancement can best be achieved by the efficient allocation of capital in the marketplace and by government programs aimed at objectives which are not met by the capital market. Such programs could offer incentives to attract the investment of pension fund assets. However, they should not seek to direct public sector pension funds to non-economic investments. Public and private sector pension funds should be governed by the same rules. The foreign property limit in the Income Tax Act (Canada) should be raised above 10 per cent.

CHAPTER 6

SEVEN PENSION DEALS: AN OVERVIEW

SYNOPSIS

This chapter provides an overview of the pension deals associated with the seven public sector pension funds included in our terms of reference. Six are defined benefit related deals, the seventh is a supplementary inflation indexing component of two of the other deals. There are wide differences with respect to benefits policy, funding policy, ownership of surplus (deficit), pension fund structure, investment policy, accountability and the process for changing the pension deal. Government roles and responsibilities in relation to the deals differ.

Introduction

The Task Force was asked to give special attention to seven public sector pension funds, namely:

- the Teachers' Superannuation Fund **(TSF)**
- the Public Service Superannuation Fund **(PSSF)**
- the Superannuation Adjustment Fund **(SAF)**
- the Ontario Municipal Employees Retirement System **(OMERS)**
- the Ontario Hydro Pension Fund **(HYDRO)**
- the Hospitals of Ontario Pension Plan **(HOOPP)**
- the Workers' Compensation Board Pension Fund **(WCB)**.

This chapter sets the stage for an analysis of these seven funds in subsequent chapters by comparing and contrasting the pension deals associated with the funds.

The Chapter is divided into three sections:

I. **Highlights of the seven funds**

II. **The formal pension deals and current practice**

III. **Pension plan roles and responsibilities**

SECTION I

Highlights of the Seven Funds

Figure 6.1 compares the seven funds in terms of the sector served, assets, employers, active plan members, beneficiaries, annual cash flow and surplus (deficit) .

Seven Public Sector Pension Funds - Comparative Highlights
December 31, 1986

Fund	Sector	Assets[1] ($ Billion)	Rank by Assets	Employers	Active Plan Members	Beneficiaries	1986 Cash Flow ($ Million)	Surplus[2] (Deficit) ($ Million)
TSF[3]	Education	10.1	1	361	140,639	29,327	1,350	742
OMERS[4]	Municipal	7.32	2	1069	140,120	33,340	1,134 [5]	504 [5]
CAATS	Education	0.86	7	22	15,655	1,607	133 [5]	59 [5]
RYERSON	Education	0.084	28	1	1,210	144	13 [5]	6 [5]
OMERS Total	Municipal & Education	8.26	2	1092	156,985	35,091	1280	569
PSSF	Government	4.03	3	33	77,294	23,742	533	110
HOOPP	Health	3.68	4	301	70,478	19,085	316	274
HYDRO	Utilities	3.28	5	1	23,542	7,691	321	399
SAF	Education & Government	1.3	6	—	219,143 [6]	30,138 [6]	214	[7]
WCB	Government	0.25	16	9	4,090	776	23	35
	Total	30.9	—	1,797	473,028	115,712	4,037	2,129

[1] Market value except for book value for non-market government debt (TSF, PSSF, SAF and part of OMERS).

[2] Actuarial valuations as of December 31, 1985, as reported by each of the funds, except December 31, 1986 for OMERS.

[3] Includes school boards where the Government acts as the employer for pension purposes.

[4] Data for OMERS excludes CAATS and Ryerson Funds. The OMERS total below includes all three funds.

[5] OMERS, CAATS and Ryerson cash flow and surplus figures are their pro-rata share of OMERS pro rated by assets.

[6] Active plan members and beneficiaries of SAF are included in TSF and PSSF totals and are therefore not reflected in the overall totals below.

[7] SAF is a modified pay-as-you-go fund and is not meant to be fully funded.

FIGURE 6.1

Together, the seven funds have assets (at market value) of $30.9 billion, or 84 per cent of the total assets of all public sector pension funds. As well, they have 1,797 employers, 473,028 active plan members, and pay benefits to 115,712 beneficiaries. They had a 1986 cash flow of $4.0 billion.

SECTION II

The Formal Pension Deals and Current Practice

Chapter 3 describes the components of a pension deal. This section compares the pension deals associated with the seven funds in terms of these components.

A comparison is made first of the formal pension deal and then of current practice since, in several cases, current practice is inconsistent with the formal pension deal.

Formal Deals

Figure 6.2 compares the formal pension deals for the seven funds.

While there are many similarities, there are many differences.

Six of the pension deals are defined benefit related deals. The SAF is a component of the TSF, PSSF and Ryerson pension deals, designed to provide supplementary pay-as-you-go inflation protection to plan members.

The employer/plan sponsor has formal responsibility for both plan administration and investment management in three deals – HYDRO, HOOPP and WCB.

For the TSF and PSSF, the employer or plan sponsor is required by legislation to share plan administration with employees, either equally or partially. Employees are not involved in plan administration for the SAF but, through the review committees, have a role in certain aspects of fund management.

The Treasurer (with the approval of the Lieutenant Governor in Council) sets the interest rate and term of the non-market government debt held by the TSF, PSSF and SAF. Once the interest rate and term of this debt is decided, there is no discretionary investment management for these funds because the assets are non-marketable.

The OMERS Board, which has both employee and employer representatives, has responsibility for both plan administration and investment management. Plan members are in the majority on the OMERS Board even though employers (i.e. taxpayers) have the responsibility for any deficit.

OMERS, HYDRO, HOOPP and WCB invest in market investments subject to the constraints imposed by the Pension Benefits Act.

Comparison of the Formal Pension Deals of Seven Pension Funds

Components Of Deal	Pension Funds						
	TSF	PSSF	SAF	OMERS	HYDRO	HOOPP	WCB
Kind of Deal	Defined Benefit	Defined Benefit	Shared Cost Inflation Protection Plan	Defined Benefit	Defined Benefit	Defined Benefit	Defined Benefit
Benefits Policy	2% per year of service based on best 5 years & inflation	2% per year of service based on best 5 years & inflation	Inflation protection up to 8% of CPI for TSF/PSSF/ Ryerson Plan members	2% per year of service based on best 5 years & inflation	2% per year of service based on best 5 years & inflation	2% per year of service based on best 5 years & inflation	2% per year of service based on best 5 years & inflation
Funding Policy	Fixed matching contribu-tions & gov't guarantee	Fixed matching contribu-tions & gov't guarantee	Fixed matching contribu-tions	Employee fixed Employer variable	Employee fixed Employer variable	Employee fixed Employer variable	Employee fixed Employer variable
Ownership of a Surplus	Not stated	Not stated	Not applicable (Pay/Go)	Not stated	Ongoing surplus not stated	Ongoing surplus not stated	Not stated
Responsi-bility for a Deficit	Plan sponsor	Employer	Not applicable (Pay/Go)	Employer	Employer	Employer	Employer
Investment Policy	Non-market gov't debt	Non-market gov't debt (Trust Account)	Non-market gov't debt (Trust Account)	Market (some residual non-market gov't debt)	Market	Market	Market
Plan Admini-stration	Shared	Partially Shared	Plan Sponsor	Shared (but plan member majority)	Employer	Plan Sponsor	Employer
Investment Management	Treasurer (limited role)	Treasurer (limited role)	Treasurer/ Review Committee (limited role)	Shared (but plan member Majority)	Employer	Plan Sponsor	Employer
Process for Changing Deal	Legislation	Legislation	Formal Committee & Legi-slation	Legislation & Regu-lations & OMERS Board initiatives	Legislation & collective bargaining & Cabinet approval	OHA decides (collective bargaining possible)	Legislation & regu-lations

Note: For an explanation of these descriptions, see the more detailed discussion in Chapters 7 to 13.

FIGURE 6.2

OMERS, HYDRO, HOOPP and WCB have fixed employee contributions and variable employer contributions. TSF, PSSF and SAF have fixed, matching employer and employee contributions.[1]

The Government guarantees that there will be sufficient monies in the TSF and PSSF to pay the pensions promised.

All of the pension deals, except the SAF, provide essentially the same pension benefits, except with respect to inflation protection. OMERS, HYDRO, HOOPP and WCB provide no formal inflation protection. Through the SAF, the TSF and PSSF provide formal inflation protection tied to the CPI up to a cap of 8 per cent.

In all of the pension deals, except the SAF, the employer alone has the liability for any deficit, through increased employer contributions. In the SAF, any deficit is shared, in that contributions are matching and vary jointly to meet expenses. However, since the SAF is not fully funded, current contributions do not cover the benefit entitlements being earned, with the result that future liabilities for current employees are being transferred to future generations.

In HOOPP, employers are not permitted to withdraw any surplus. However, because their contributions are variable, based on the funding status of the fund, employers may reduce their contributions in the event of a surplus. The HOOPP Fund must be used for the exclusive benefit of plan members and any surplus on plan termination must be used for the benefit of plan members.

There is no reference to how any surplus should be dealt with in the TSF, PSSF, OMERS or WCB. For HYDRO, the only provision is that, if the plan is terminated, any surplus reverts to the employer.

The formal process for changing the pension deal also varies widely. For the TSF and PSSF, the deal can be changed only by legislation. The SAF has formal committees for reviewing and making recommendations on the rate of contribution to the fund and the term of the investments of the fund, but again the deals can be changed only by legislation.

OMERS and WCB can be changed on the initiative of their respective Boards, but the changes are subject to Cabinet or legislative approval.

HYDRO changes are initiated through collective bargaining but, again, are subject to Cabinet or legislative approval.

HOOPP does not preclude collective bargaining. However, there are practical difficulties due to the structure of the hospital industry. As a result, collective bargaining is not used to determine pension benefits.

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[1] Contributions to the CPP are made on earnings below a Yearly Maximum Pensionable Earnings level. In 1987, this maximum is $25,900. Below that level, CPP contributions by employers and employees are integrated with their contributions to the TSF, PSSF, OMERS, HYDRO, HOOPP and WCB pension funds; that is, combined contributions by employers and employers to the CPP and the pension fund on earnings below the CPP maximum in the past was the same percentage as the pension contributions alone above the CPP earnings maximum.

However, beginning in 1987, CPP contribution rates are scheduled to increase each year (see Figure 16.2 in Chapter 16). These increases are added to the total contribution rates up to the CPP maximum earnings level; there is no effect on contribution rates above that level. In 1987, the increase in CPP contribution rates was 0.1 per cent.

Current Practice

Figure 6.3 compares current practice for the seven funds with the formal pension deal. The differences are identified by the shaded areas.

Four of the seven pension deals – TSF, OMERS, HOOPP and WCB – have changed from defined benefit related deals to defined benefit deals with a shared surplus or plan member surplus.

The WCB and HOOPP have shared past surpluses with plan members in the form of benefit improvements and ad hoc inflation adjustments. OMERS has used past surpluses for benefit improvements and ad hoc inflation protection. To date, OMERS employers have never benefited directly from a surplus.

The TSF surpluses have been used to fund an early retirement program and to reduce unfunded liabilities.

OMERS, HYDRO, HOOPP and WCB have improved benefit levels and have provided ad hoc inflation protection. Recent ad hoc inflation adjustments have been paid for from surpluses. Earlier inflation adjustments (before a surplus arose) were paid for in HYDRO, HOOPP and the WCB from additional employer contributions. OMERS has been able to pay for benefit improvements from its surplus, with the help of an increase in both employer and employee contribution rates when the plan was changed from a career average to a final average formula.

Only OMERS has changed the formal deal with respect to funding. While the formal OMERS deal calls for variable employer contributions, the current practice is for the employer to match employee contributions.

There is no difference between the formal deal and current practice with respect to investment policy or the responsibility for a deficit in any of the seven pension deals.

The current practice for changing the pension deal is different for two plans – TSF and PSSF. In the case of the TSF, a formal Biennial Review Committee was established to recommend changes. A new forum is being developed. Until recently, changes to the public service pension deal were discussed informally with the employee representatives. Recently, this process has been formalized.

HOOPP now has four union representatives on the pension committee. This has resulted in a partial sharing by the employer with employee representatives of both plan administration and investment decision-making.

Comparison of Current Practice of Seven Public Sector Pension Funds

Components of Deal	TSF	PSSF	SAF	OMERS	HYDRO	HOOPP	WCB
Kind of Deal	Defined Benefit & shared surplus	Defined Benefit	Shared cost inflation Protection Plan	Defined Benefit & plan member surplus	Defined Benefit	Defined Benefit & Shared Surplus	Defined Benefit & Shared Surplus
Benefits Policy	2% per year of service based on best 5 years & inflation	2% per year of service based on best 5 years & inflation	Provides inflation protection up to 8% of CPI for TSF, PSSF, Ryerson plan members	2% per year of service based on best 5 years & ad hoc inflation	2% per year of service based on best 5 years & ad hoc inflation	2% per year of service based on best 5 years & ad hoc inflation	2% per year of service based on best 5 years & ad hoc inflation
Funding Policy	Fixed matching contribu-tions & gov't guarantee	Fixed matching contribu-tions & gov't guarantee	Fixed matching contribu-tions	Matching	Employee fixed Employer variable	Employee fixed Employer variable	Employee fixed Employer variable
Ownership of a Surplus	Shared	No distribution	Not applicable (Pay/Go)	Plan Members	Ongoing surplus shared	Shared	Shared
Responsi-bility for a Deficit	Plan Sponsor	Employer	Not applicable (Pay/Go)	Employer	Employer	Employer	Employer
Investment Policy	Non-Market gov't debt	Non-Market gov't debt (trust account)	Non-Market gov't debt (trust account)	Market (some residual non-market gov't debt)	Market	Market	Market
Plan Adminis-tration	Shared	Partially Shared	Plan Sponsor	Shared but plan member majority	Employer	Partially Shared	Employer
Investment Manage-ment	Treasurer (limited role)	Treasurer (limited role)	Treasurer/ Review Committee (limited role)	Shared but plan member majority	Employer	Partially Shared	Employer
Process for Changing Deal	Legislation & Formal discussion	Legislation & Formal discussion	Legislation & Formal Committee	Legislation & Regulations & OMERS Board initiatives	Legislation & Collective Bargaining & Cabinet approval	OHA decides (collective bargaining possible)	Legislation & regula-tions & WCB initiatives

Note: For an explanation of these descriptions, see the more detailed discussion in Chapters 7 to 13.

FIGURE 6.3

How the Pension Deal is Changed

Figure 6.4 illustrates how the pension deal is changed for each of the seven funds, ranging from formal collective bargaining in a total compensation context with Ontario Hydro, to formal discussions for the teachers, followed by legislation. Crown employees are prohibited by legislation from bargaining for pensions. This applies to the PSSF, SAF and WCB. Teachers likewise cannot bargain collectively for pensions. The basic OMERS plan also cannot be bargained but certain additional benefits can.

Changing The Pension Deal in Seven Public Sector Pension Plans: Actual Practice

Pension Plan	Change Process	Comments
TSF	A formal biennial review between the Ontario Teachers' Federation and the Ministry of Education.	Any change to the deal requires a change in the Teachers' Superannuation Act.
PSSF	Collective bargaining for pensions prohibited by law. Formal discussions with OPSEU occur.	Any change to the deal requires a change in the Public Service Superannuation Act.
SAF	Collective bargaining prohibited. Joint committee reviews contribution level.	Any change to the deal requires a change in the Superannuation Adjustment Benefits Act.
OMERS	Changes to the pension deal are proposed by the OMERS Board.	Cabinet approval needed for changes in benefit levels and employee contributions. More fundamental changes may require a change in the OMERS Act.
HYDRO	Principally collective bargaining.	Cabinet approval needed for benefit improvements. More fundamental changes may require a change in the Power Corporation Act.
HOOPP	Changes are initiated by the OHA. Collective bargaining is not prohibited but structural barriers make bargaining impractical.	No Cabinet or legislative approval is needed to change the pension deal.
WCB	Collective bargaining prohibited. Changes are initiated by WCB Board.	Cabinet approval needed for benefit improvements & changes to funding levels. More fundamental changes may require changes to the Workers' Compensation Act.

FIGURE 6.4

Looked at solely from the point of view of how contribution rates and benefit levels are changed, there is a comparable diversity among the seven pension deals as is illustrated in Figure 6.5.

Type of Approval Required to Change Benefit Levels and Contribution Rates

Fund	Legislation	Regulations
TSF	Benefit levels Contribution rates	Some benefit related matters
PSSF	Benefit levels Contribution rates	Some benefit related matters
SAF	Benefit levels Contribution rates	—
OMERS	—	Benefit levels, employee contribution rates
HYDRO	—	Benefit levels, employee contribution rates (Hydro Board initiates)
HOOPP	—	—
WCB	—	Benefit levels, employee contribution rates (WCB initiates)

FIGURE 6.5

Legislation is required to change benefit and contribution rates for teachers and the public service. Regulations approved by the Lieutenant Governor in Council (i.e. the Ontario Cabinet) are required to change OMERS benefit levels and contribution rates. No Government action is required to change HOOPP benefit levels and contribution rates.

Approval by the Lieutenant Governor in Council is required to ratify regulations which the Ontario Hydro and the WCB Boards make to change benefit levels and contribution rates.

Fund Surpluses (Deficits) & Employer Contributions

Figures 6.6 and 6.7 compare the surpluses (deficits) of six large public sector funds with employer contributions for the period 1976-1985. The employer contribution is shown as a percentage of the employee contribution. Figure 6.6 covers the TSF, PSSF and OMERS, while Figure 6.7 covers HYDRO, HOOPP and WCB.

With the exception of Ontario Hydro since 1985 and OMERS in 1984 and 1986, all employer contributions matched or were greater than employee contributions during this 10 year period.

There is considerable variation among the funds in the relationship between surpluses (deficits) and employer contributions. Some funds such as the WCB and HOOPP have had higher employer contributions even while the fund was in surplus regardless of the surplus (deficit) situation. Other contribution ratios have tended to decline as the surplus increases but the pattern is not consistent.

Comparison of Surpluses (Deficits) and Employers' Contributions

Years	TSF		PSSF		OMERS	
	Surplus (Deficit) ($ Million)	Ratio of Employers' Contribution to Employees' %	Surplus (Deficit) ($ Million)	Ratio of Employers' Contribution to Employees' %	Surplus (Deficit) ($ Million)	Ratio of Employers' Contribution to Employees' %
1976	(1397)	132	(505)	148	61	100
1977	(1397)	202	(507)*	180	111	100
1978	(1096)	317	(434)*	152	(115)	101
1979	(1096)	255	(316)	187	(71)	103
1980	(1096)	243	(271)*	181	(15)	101
1981	(433)	168	(184)*	154	248	100
1982	(433)	167	(121)	149	168	101
1983	(433)	120	85*	143	10	101
1984	693	115	128*	114	109	98
1985	742	119	110	114	227	100
1986	n/a	108	n/a	113	569	99
1987	n/a	n/a	n/a	n/a	n/a	100

* Interim valuations

Source: Public Sector Pensions Advisory Board staff and individual funds.
Note: For explanation of the data for the individual funds, see Chapters 7, 8 and 10.

FIGURE 6.6

Comparison of Surpluses (Deficits) and Employers' Contributions

Years	HYDRO		HOOPP		WCB	
	Surplus (Deficit) ($ Million)	Ratio of Employers' Contribution to Employees' %	Surplus (Deficit) ($ Million)	Ratio of Employers' Contribution to Employees' %	Surplus (Deficit) ($ Million)	Ratio of Employers' Contribution to Employees' %
1976	(143)	332	(122)	158	13	245
1977	(133)	430	(90)	158	13	235
1978	90	408	(74)	158	17.7	215
1979	81	222	(35)	158	17.7	100
1980	17	178	32	158	17.7	107
1981	28	223	52	157	9	109
1982	16	213	100	158	9	131
1983	115	208	141	135	9	109
1984	221	148	259	120	35	109
1985	399	58	274	101	35	106
1986	n/a	16	n/a	100	n/a	113
1987	n/a	0 *	n/a	100	n/a	113

* Subject to final Hydro Board approval.
Source: Public Sector Pensions Advisory Board staff and individual funds.
Note: For explanation of the data for the individual funds, see Chapters 11, 12 and 13.

FIGURE 6.7

SECTION III

Pension Plan Roles and Responsibilities

This section compares and contrasts the seven pension deals in terms of who has what roles and responsibilities. See Figure 6.8. Where possible, the governors of the seven funds are identified, as are those to whom they are accountable.

Finally, this section examines the extent to which employees are involved in pension plan administration and investment management.

Pension Plan Roles and Responsibilities

ROLES	PENSION PLANS						
	TSF	PSSF	SAF	OMERS	HYDRO	HOOPP	WCB
Sponsor	Province	Province	Province	Province	Ontario Hydro	Ontario Hospital Ass'n. (OHA)	WCB
Employer	School boards, private schools & others	Province & various boards & commis- sions	School boards & Province & Ryerson & private schools & others	Municipal gov't & local agencies	Ontario Hydro	211 hospitals & other health agencies	WCB & 8 safety associa- tions
Employer Contributor	Ministry of Education & private schools & others	Province & various boards and commis- sions	Province & Ryerson & private schools & others	Municipal Gov't & local agencies	Ontario Hydro	211 hospitals & other health agencies	WCB
Custodian	Treasurer	Treasurer	Treasurer	OMERS Board	Ontario Hydro (implicit)	Trust Company	None designated
Trustee	None designated	None designated	None designated	None designated	Ontario Hydro (implicit)	Trust Company	None designated
Investment Policy Maker	Legislature	Legislature	Legislature	OMERS Board	Ontario Hydro Board	Ontario Hospital Ass'n. Board	WCB Board
Investment Manager	Treasurer (limited role)	Treasurer (limited role)	Treasurer/ Review Committees (limited role)	OMERS staff	Ontario Hydro staff	OHA staff	WCB staff
Statutory Guarantor	Province	Province	None	None	None	None	None

FIGURE 6.8

The Province of Ontario is the plan sponsor for the TSF, PSSF, OMERS and SAF.

The Province is the principal employer contributor for the TSF, PSSF and SAF. It is the major employer for the PSSF. Because the Province is the contributor but not the direct employer for teachers, we will use the term "employer for pension purposes" to describe its role in respect of the TSF.

The Provincial Treasurer is the custodian for the TSF, PSSF and SAF.

HOOPP is the only fund with an independent trustee.

For the TSF, PSSF, SAF, HYDRO, HOOPP and WCB, the plan sponsor and the investment policy maker are the same. The OMERS Board is the investment policy maker for the OMERS Fund.

The plan sponsor and/or employer is the investment manager for HYDRO, HOOPP and WCB. Because the assets of the TSF, PSSF and SAF are not marketable, there is no discretionary investment management for these funds. The Treasurer (subject to the approval of the Lieutenant Governor in Council) sets the interest rate and term of the non-market government debt.

The Province specifically guarantees the pensions promised for the TSF and PSSF. This statutory guarantee is in addition to the Province's covenant as the employer/plan sponsor to pay the pensions promised.

Accountability of Investment Fiduciaries

In chapter 5, we discussed the accountability of pension fund governors. Here we compare the seven funds in terms of:

- who are the primary governors?
- to whom are they accountable?
- how is their performance measured?
- how are they held to account?

Figure 6.9 compares the seven funds in these terms.

There is uncertainty about who the primary governors are for each of the TSF, PSSF and SAF. Even if no change is made in the way the TSF, PSSF and SAF are invested, the Pension Benefits Act, 1987 will require, among other things, the designation of an administrator for each of these funds so that the primary fiduciary responsibility is unequivocally assigned.

The information provided by each fund to its plan members and to other persons to whom it is accountable varies widely in terms of completeness. In our view, OMERS provides the most complete and readable report of the seven funds.[2]

How the performance of the governors is measured and who actually measures them is unclear, as is the process by which the governors are held to account.

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[2] See Appendix M, *Reporting on Public Sector Pension Funds.*

Pension Fund Governors and Accountability

Fund	Who are the Governors?	To Whom Accountable?
TSF	Uncertain – some possibilities: • Treasurer as custodian • Lieutenant Governor in Council which sets interest rate and term • Province as sponsor • Minister of Education as responsible for the Act	Pension Commission Plan Members Cabinet (via Minister of Education) Legislature
PSSF	Uncertain – some possibilities: • Treasurer as custodian • Lieutenant Governor in Council which sets interest rate and term • Province as sponsor • Chairman of Management Board as responsible for Act	Pension Commission Plan Members Cabinet (via Chairman of Management Board) Legislature
SAF	Uncertain – some possibilities: • Treasurer as custodian • Lieutenant Governor in Council which sets interest rate and term • Province as sponsor • Chairman of Management Board as responsible for Act	Pension Commission Plan Members Other Employers Cabinet (via Chairman of Management Board) Legislature
OMERS	Board of OMERS	Pension Commission, Plan Members, Employers, Cabinet (via Minister of Municipal Affairs)
HYDRO	Ontario Hydro Board of Directors	Pension Commission, Plan Members, Cabinet (via Minister of Energy)
HOOPP	Board of Directors of the Ontario Hospital Association	Pension Commission, Plan Members, Employers Ministry of Health (re hospital grants)
WCB	WCB Board	Pension Commission, Plan Members, Employers, Cabinet (via Minister of Labour)

FIGURE 6.9

Plan Member Involvement in Plan Administration and Investment Management[3]

Plan members are involved in plan administration and investment management in each of these seven deals in varying degrees. See Figure 6.10.

[3]Plan member involvement in plan management does not refer to management employees who represent the employer or plan sponsor. Included, however, are union representatives even if they are not actual employees or plan members.

Plan Member Involvement in Plan Administration and Investment Management

Plan/Fund	Plan Administration	Investment Management
TSF	Teachers have equal representation on the Teachers' Superannuation Commission which administers the plan.	Investment policy set by legislation. Teachers have input into the terms of the non-market government debt.
PSSF	The Chairman of Management Board administers the plan. A representative of plan members serves on the Board which advises the Chairman.	Investment policy set by legislation. No plan member input.
SAF	None	Investment policy set by legislation. Review committees (50% employees) recommend term of non-market government debt.
OMERS	OMERS Board administers the plan. At least 8 out of 11 members of the Board are plan members.	OMERS Board sets investment policy. OMERS staff manage investments.
HYDRO	None (Advisory Committee planned)	None
HOOPP	The 20 member HOOPP Pension Committee administers the plan. Four union representatives serve on the Pension Committee.	The OHA Board makes investment policy decisions. The Pension Committee recommends investment policy. Four union representatives sit on Pension Committee.
WCB	None	None

FIGURE 6.10

For the most part, employees are involved in plan administration but not in investment management. OMERS is the exception. In the case of OMERS, plan members comprise the majority of the OMERS Board.

Four union representatives are members of the HOOPP pension committee, making up 20 per cent of the total membership of that committee.

Conclusion

This overview has compared the pension deals associated with the seven public sector pension funds included in our terms of reference. It has also identified areas of divergence between the formal pension deals and current practice.

Chapters 7-13 examine each of these pension deals in greater detail and recommend the changes needed to resolve problems in the formal pension deals related to the seven funds and the differences between the formal deals and current practice.

CHAPTER 7

TEACHERS' SUPERANNUATION FUND (TSF)

SYNOPSIS

The current teachers' pension deal should be changed. Teachers and their representatives have proposed that the TSF invest in market investments on the assumption that they own any surplus. They have also proposed that teachers have at least joint control of the TSF. The Task Force agrees that the TSF should invest in market investments. However, under the present pension deal, any investment risk surplus should benefit the taxpayer, since the taxpayer is required to make up any deficit in the TSF. The TSF should have its own independent board of governors, including a minority of plan members. Teachers may prefer to replace their current defined benefit related pension deal with a shared risk/reward or a defined contribution deal.

Introduction

This chapter reviews the current pension deal with teachers, the changes teachers and their representatives want to their deal and the implications of those changes. It also recommends changes to the current pension deal, and discusses alternatives for a new kind of pension deal for teachers.

Figure 7.1 provides an overview of the TSF.

Overview of the TSF

December 31, 1986

Fund	Sector	Assets * ($ Billion)	Rank by Assets	Employers**	Active Plan Members	Beneficiaries	1986 Cash Flow ($ Million)	Surplus *** (Deficit) ($ Million)
TSF	Education	10.1	1	361	140,639	29,237	1,350	742

* Book value. The imputed market value is $11.11 billion. This amount does not include the teachers' portion of the SAF. See Chapter 9.

** Includes 169 school boards and school districts where the Government is the employer for pension purposes.

*** Actuarial valuation as of December 31, 1985.

FIGURE 7.1

The TSF is Ontario's largest public sector pension fund with assets at book value of more than $10 billion as at December 31, 1986. The Province is the plan sponsor and the principal employer/contributor to the fund. There are over 140,000 active plan members and over 29,000 plan beneficiaries. Cash flow in 1986 was $1.35 billion. The TSF had a surplus of $742 million as of December 31, 1985.

The chapter is divided into five sections:

I. **The pension deal**

II. **Teachers' views**

III. **Changes needed to the pension deal**

IV. **A possible new pension deal**

V. **Clarifying Government and school board roles**

SECTION I

The Pension Deal

Roles of Participants

The teachers' pension deal is set out in the Teachers' Superannuation Act and the Superannuation Adjustment Benefits Act.[1]

Figure 7.2 summarizes the roles and responsibilities of the various parties to the teachers' pension deal.

TSF Roles and Responsibilities

Sponsor	Employer *	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
Province	School Boards, Private Schools and Others	Ministry of Education, Private Schools and Others	Treasurer	None Designated	Legislature	Treasurer (limited role)

* The Ministry of Education is the employer for pension purposes for teachers employed by 169 school boards and school districts. The Province also guarantees the pension promise.

FIGURE 7.2

[1] See Chapter 9 for a description of those components of the teachers' pension deal set out in the Superannuation Adjustment Benefits Act.

The Province of Ontario is the plan sponsor and the employer for pension purposes for teachers employed by school boards and school districts.

Three major groups make employer contributions to the TSF, namely the Ministry of Education on behalf of school boards and school districts, 123 designated private schools and 68 other employers such as community colleges. In addition, over 140,000 teachers make employee contributions to the TSF. See Figure 7.3.

Contributors to the TSF

December 31, 1985

	Employer Contributors	Teacher Contributors
Ministry of Education	1 *	145,002
Private Schools	123	1,328
Others	68	2,064
Total	**192**	**148,394 ****

* The Ministry is the employer for pension purposes for teachers employed by 169 school boards.
** The actual number of teacher contributors is about 5 per cent lower because some teachers work at two different institutions.

FIGURE 7.3

Approximately 95 per cent of the teachers participating in the TSF are members of the five teacher organizations represented by the Ontario Teachers' Federation (OTF), namely:

- l'association des enseignantes et des enseignants franco-ontariens
- the Federation of Women Teachers' Associations of Ontario
- the Ontario English Catholic Teachers' Association
- the Ontario Public School Teachers' Federation
- the Ontario Secondary School Teachers' Federation

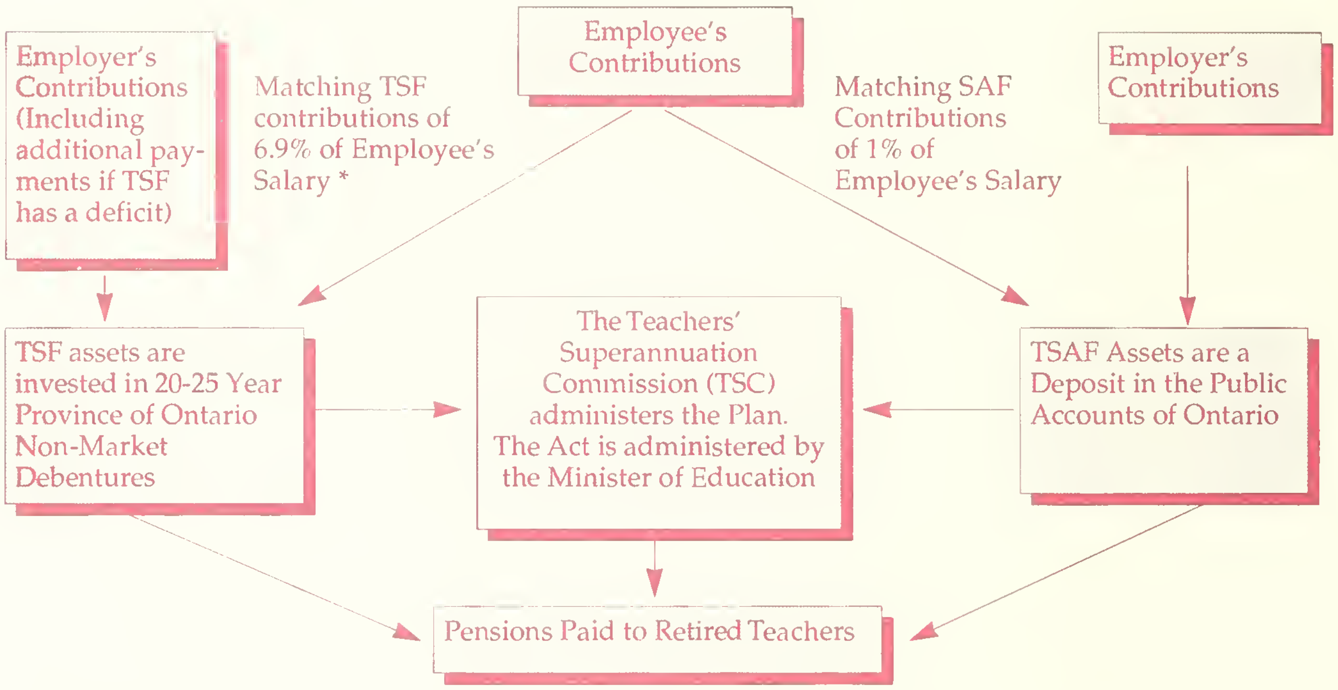
The Treasurer of Ontario is the custodian of the TSF. No trustee has been appointed. The Legislature has determined how the assets of the TSF are to be invested and so is the investment policymaker. There is no discretionary investment management because the assets of the TSF are non-marketable.

The Minister of Education administers the Teachers' Superannuation Act. The Chairman of Management Board administers the Superannuation Adjustment Benefits Act.[2]

Relationship of the Participants

Figure 7.4 illustrates the relationship among the various parties involved in the TSF and TSAF.

TSF Structure and Decision -Making Relationships



* Contributions to the TSF are approximately 6.9 per cent of salary, less contributions to the CPP on CPP contributory earnings (up to $25,900 in 1987).

FIGURE 7.4

The Teachers' Superannuation Commission (TSC) administers the plan and advises the Minister of Education on matters related to the affairs of the TSC and the administration of the Act. The TSC has five teacher representatives (each of the five teacher organizations elects a representative) and five government or employer representatives (appointed by the Minister of Education). The Chairman is selected from either group in alternate years.

Growth of the Fund

The growth of the TSF since 1965 is illustrated in Figure 7.5.

[2] The teachers' portion of the SAF is known as the Teachers' Superannuation Adjustment Fund (TSAF).

Growth of the TSF ~ 1965 - 1986

Year	Assets * ($ Billion)	Active Plan Members	Annual Contributions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1965	0.4	82,566	44	7,002	15
1975	1.0	137,280	169	17,113	102
1980	4.0	133,181	285	21,839	173
1986	10.1	140,639	587	29,237	397

* Book value

FIGURE 7.5

Since 1965, the book value of assets has increased by over 25 times, the number of active plan members has increased by over one half, the number of pensioners has increased by over four times and the annual pension benefits paid have increased by over 26 times.

The TSC forecasts that TSF assets will grow to over $15 billion by the end of 1989. Figure 7.6 shows the projected annual increases in TSF assets over the next three years.[3]

Forecast Growth of TSF Assets ~ 1986 - 1989

Year	Annual Net Increase ($ Billion)	Total Assets * ($ Billion)
1986	1.35	10.10
1987	1.50	11.67
1988	2.10	13.77
1989	1.90	15.67

* Book value

FIGURE 7.6

The TSC also forecasts that pension benefits paid will exceed employee contributions in the period 1990-1994 and employee and employer contributions in the period 2000-2004, and that the TSF will "dip into" the interest income generated by fund investments to pay pension benefits around 2002.[4] Nevertheless, the TSC forecasts that the TSF will continue to grow from interest income and should not need to liquidate long term investments to pay pension benefits.

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[3] Teachers' Superannuation Commission (TSC) Brief to the Task Force on the Investment of Public Sector Pension Funds, March 1987, pp. 6-7.

[4] TSC Brief, p. 12

The rising interest income component of the TSF's annual revenue stream is shown in Figure 7.7.

Interest Income Component of the TSF Revenue Stream ~ 1983 - 1986

	1983 ($ Billion)	1984 ($ Billion)	1985 ($ Billion)	1986 ($ Billion)
Interest Income	0.624	0.754	0.897	1.022
Contributions	0.435	0.521	0.569	0.587
Total	**1.059**	**1.275**	**1.466**	**1.609**
Interest Income as Percentage of Total	59%	59%	61%	63%

FIGURE 7.7

Record of Surpluses and Deficits and Employer Contribution Rates

Figure 7.8 illustrates the record of surpluses and deficits in the TSF since 1976, and the contributions of the employers for pension purposes as a percentage of teacher contributions each year over the same period.[5]

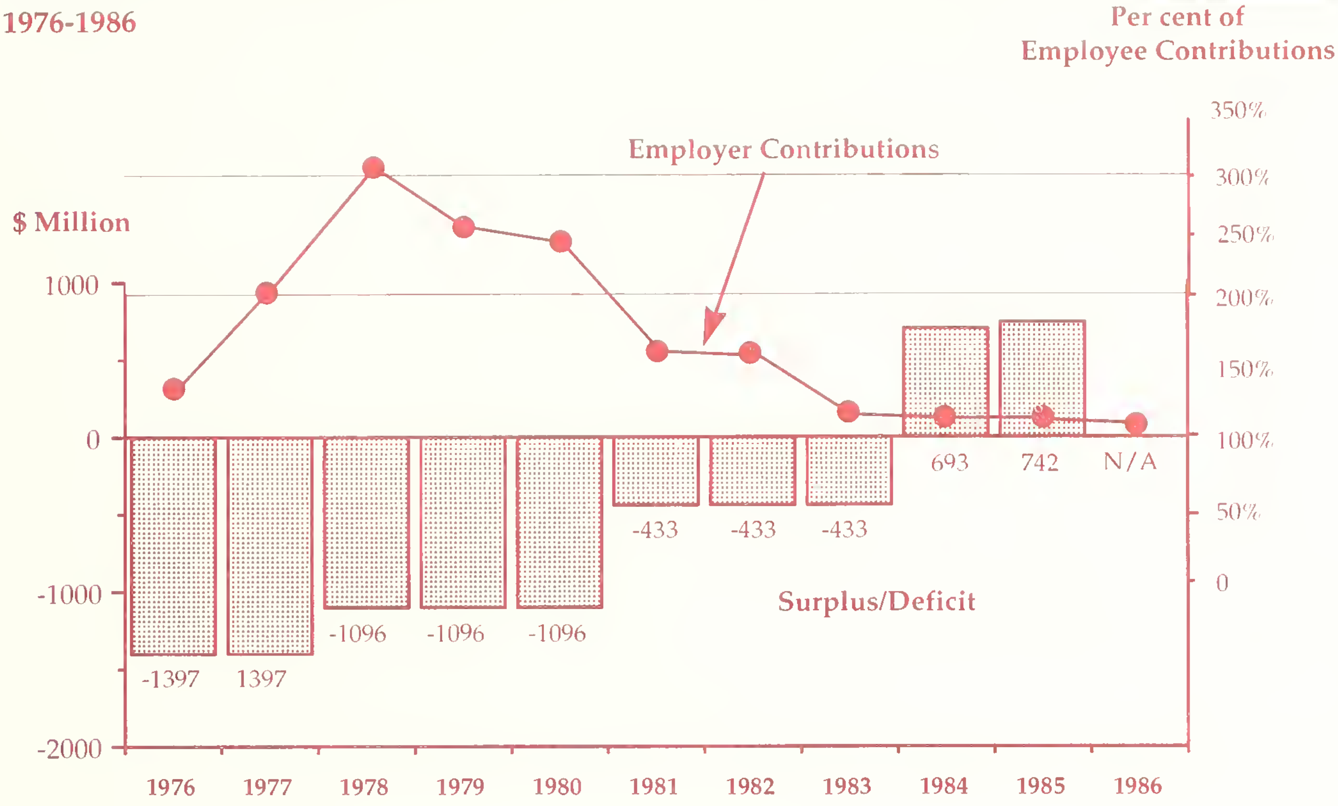
The TSF had a deficit every year between 1976 and 1983, peaking at $1,397 million in 1976 and 1977. The deficit gradually declined until the first surplus arose in the December 31, 1984 actuarial valuation. The valuation as of December 31, 1985 showed a surplus of $742 million.

[5] Although the contributions of the employer for pension purposes and the teachers are "matching," they are unlikely to be equal for any reporting period for the following reasons:

- The matching contributions from the Province made in a given year are equal to the teachers' contributions for the year preceding the current year.
- Interest in respect of this delay is payable for the 19 month period ending December 31 of the current year.
- The Province also makes special payments in respect of any deficit in the TSF. However, no such payments were required in 1986 and none are anticipated in 1987.

Comparison of the TSF Surplus (Deficit) and the Employer Contributions as a Percentage of Employee Contributions

1976-1986



Source: Public Sector Pensions Advisory Board Staff and Teachers' Superannuation Commission

FIGURE 7.8

Because of the requirement to make additional payments to the TSF in light of the deficit which existed until 1984, the contributions of the employer for pension purposes have exceeded teacher contributions each year, peaking at 317 per cent in 1978.[6]

Investment Management

The Teachers' Superannuation Act requires TSF assets not needed for current expenditures be invested in Province of Ontario debentures.[7]

The Treasurer, in consultation with the TSC and subject to the approval of the Lieutenant Governor in Council, determines the interest rate[8] and term of the debentures (20 to 25 years).

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[6] All additional payments in respect of deficits in the TSF have been made by the province and none by other participating employers such as private schools. Since the legislation was changed in 1984 to require all participating employers to make additional payments in respect of deficits, the fund has been in surplus so no such additional payments have been made.

[7] The debentures cannot be traded and are therefore referred to as "non-market government debt."

[8] The Teachers' Superannuation Act provides that the interest rate be based on the effective interest rate payable in the Canadian secondary market on government or government guaranteed debt having the same term and is to be payable half yearly.

The TSF currently holds 28.6 per cent of Ontario's debt incurred for the Province's own purposes.[9]

Formal Pension Deal vs Current Practice

Figure 7.9 compares the formal pension deal for teachers with current practice and identifies areas of difference (represented by the shaded areas).

TSF ~ Formal Pension Deal

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit *	2% per year of service based on best 5 years + inflation	Fixed matching contributions + government guarantee	Surplus: not stated Deficit: plan sponsor	Non-market government debt (debentures)	Plan Administration: shared Investment Management: Treasurer (limited role)	Legislation

*See "Problems with the Formal Pension Deal" below.

TSF ~ Current Practice

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit + shared surplus	2% per year of service based on best 5 years + inflation	Fixed matching contributions + government guarantee	Surplus: shared Deficit: plan sponsor	Non-market government debt (debentures)	Plan Administration: shared Investment Management: Treasurer (limited role)	Legislation + formal discussion

FIGURE 7.9

The **formal pension deal** with teachers can be summarized as follows:

- The pension deal is nominally a defined benefit related deal.
- The pension benefit is determined by a formula based on a combination of years of service and the average salary earned in the best five years of service.

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[9] See Figure 1.12, Chapter 1.

- Inflation protection is provided through the TSAF (see Chapter 9) largely on a pay-as-you-go basis. The TSF benefit is automatically indexed to the CPI up to a cap of 8 per cent, with a carry over for any CPI increase above 8 per cent.
- The Province is the plan sponsor and the employer for pension purposes, for teachers employed by school boards and school districts.
- The Province guarantees the pension promise in that, if the payments into the TSF in any year are insufficient to pay pension benefits promised to teachers, the deficiency will be made up out of the Consolidated Revenue Fund.
- The teachers and the employers (including the Ministry of Education as the employer for pension purposes of teachers employed by school boards and school districts) make fixed matching contributions to both the TSF and TSAF.
- The employers for pension purposes are responsible for any deficit in the TSF.
- Who owns a surplus is not stated.
- Changing the deal requires a change to the Teachers' Superannuation Act and/or the Superannuation Adjustment Benefits Act.
- Investment policy is set by legislation. The TSF is required to invest in 20 to 25 year non-market government debentures.
- There is no discretionary investment management because the assets of the TSF are non-marketable. The Treasurer, subject to consultation with the TSC and the approval of the Lieutenant Governor in Council, sets the interest rate payable and the term of the debentures.
- Plan administration is shared through the TSC.
- There is no collective bargaining for pension benefits. Any changes to the pension deal require changes in the Teachers' Superannuation Act or the Superannuation Adjustment Benefits Act.

Current practice differs from the formal pension deal in two ways:

- First, some of the surplus has been shared: part was applied to eliminate an unfunded liability (which is the responsibility of the employers for pension purposes); part is being used to fund an early retirement program negotiated by the OTF with the Province for certain teachers.
- Second, while there is no collective bargaining for pensions, there are formal discussions between government representatives and the OTF over pension benefits and other aspects of the pension deal, through a Biennial Review Committee.[10]

[10]The Task Force has been informed that this committee will be replaced by another formal mechanism still to be determined.

Problems with the Formal Pension Deal

The formal pension deal is difficult to classify. While it is nominally a contributory defined benefit related deal, and the employers for pension purposes are responsible for any deficit, the fact that there are matching employer and employee contributions is more consistent with a combined defined benefit/asset related deal.

In addition, there are a number of problems with the formal pension deal.

- First, there is a lack of clarity with respect to who owns a surplus. The employers for pension purposes bear the burden of any deficit, but the deal is silent on who benefits from any surplus. Surpluses have been used to offset unfunded liabilities in the past, thereby benefiting employer contributors. They have also been used to fund an early retirement program negotiated by the OTF with the Government, thereby benefiting some plan members. As of December 31, 1985, a $742 million undistributed surplus remained in the TSF.
- Second, decisions relating to the TSF formally are made independently of decisions relating to the TSAF even though both are part of the teachers' pension deal. While representatives of the teachers and the employer for pension purposes say they are conscious of the linkage, there is no evidence to suggest that decisions about the TSF and the TSAF are made in concert.
- Third, future liabilities in the TSAF are not being funded on an ongoing basis as they are in the TSF. Currently, the TSF has a surplus, while the TSAF, if it were being funded like the TSF, would have a large deficit. As a result, future liabilities of the TSAF with respect to current teachers are being passed on to future generations of teachers and taxpayers.
- Fourth, the roles of employer and contributor are divided for those teachers who are employed by school boards and school districts. Consequently, salary and pension benefit decisions are made separately by different persons and not in a total compensation context (see Section V).

SECTION II

Teachers' Views

This section reviews comments received from teachers and their representatives and the Task Force's response.

We received briefs from the Ontario Teachers' Federation, Ontario Secondary School Teachers' Federation, Superannuated Teachers of Ontario, two local teacher groups and several individual teachers. We also received a brief from the Teachers' Superannuation Commission containing factual information and forecasts relating to the TSF.

We did not receive a brief from the Ministry of Education but we did have discussions with staff of the Ministry.

Teachers' comments fall into two categories:

- those advocating changes in certain aspects of the deal:
  - ownership of a surplus (deficit)
  - pension fund structure and control
  - investment policy
- those advocating maintaining aspects of the deal:
  - no linkage of salary and pension benefits
  - Government statutory guarantee
  - separation of the TSF and TSAF
  - employer contribution rates
  - centralization of pension funds

Changing the Deal

Ownership of a Surplus (Deficit)

Teachers want ownership of any surplus in the TSF. Except as noted below, we do not endorse this position.

In Chapter 3, we advanced the proposition that a surplus can have two parts:

- an investment risk surplus, and
- an actuarial surplus.[11]

This distinction is useful in thinking through which party or parties may be entitled to which parts of a surplus, although the assumptions underlying an existing actuarial surplus may not have been structured so as to assist in allocating it.

There is a plausible argument, particularly in the context of a contributory defined benefit pension deal with matching contributions (such as the teachers' plan), that plan members may be entitled to a share of an actuarial surplus. This argument is based on the view that, if employee contribution rates are determined, explicitly or implicitly, on the basis of conservative (as opposed to best estimate) actuarial assumptions, leading to an actuarial surplus, employees are entitled to that part of the actuarial surplus that results from their over-contributions.

We believe that a large part of the TSF surplus since 1984 is an actuarial surplus. Our rationale is that:

- The rate of return assumed by the actuary was essentially equivalent to a risk-free rate of return (i.e. approximately 2 per cent real).
- The employer and teacher contribution rates of 6.9 per cent each, set in 1983, were considered necessary to fully fund the TSF.

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[11] An investment risk surplus (or deficit) results from adopting an investment policy with a level of risk above that related to an investment policy that is essentially risk free.

An actuarial surplus is the remainder of any surplus and results from actual experience being better than the actuary assumed.

- The rate of return of a risk-free investment such as Treasury Bills over the past few years has been higher than the actuarial interest assumptions for the TSF.

However, we are not in a position to identify what portion of the $742 million surplus in the TSF as of December 31, 1985 is an actuarial surplus. Nor can we determine whether any of that actuarial surplus resulted from over-contributions by teachers on the basis of conservative actuarial assumptions.

In addition to the actuarial surplus, we also believe that part of the TSF surplus since 1984 is an investment risk surplus. Our rationale is that the employers for pension purposes have taken additional risk above a risk-free rate of return, by investing in a portfolio exclusively made up of long term, non-market debt. The additional return above the risk-free level from these investments has led to an investment risk surplus. This investment risk surplus should be to the benefit of the employers for pension purposes (i.e. the taxpayer).

This leaves unanswered the question: who should be responsible for an actuarial deficit if actuarial assumptions are wrong?

Some union representatives have argued that history shows there is a much greater chance of there being an actuarial surplus than a deficit because actuaries use very conservative assumptions. This is another way of arguing that an employee's contribution rate is usually set too high.

While, as noted earlier, this argument may be correct, history also shows that employers have had to make considerable extra payments to cover deficits which arose, at least in part, because the actuarial assumptions were wrong (i.e. experience deficiencies). See Figure 7.8.

The responsibility for such deficits in a defined benefit related deal rests with the employer and, in our view, should continue to do so.

Pension Fund Structure and Control

The OTF wants to participate equally in the process for determining the structure of the TSF. However, as long as the Province is plan sponsor and continues to provide its statutory guarantee, the OTF is willing to share control of the TSF with the Government.

We do not endorse this position. We believe that some plan member participation in the TSF is appropriate. But, so long as the employer for pension purposes has explicit liability for any deficit, particularly an investment risk deficit, we believe the employer for pension purposes should control investment decisions.

Investment Policy

Teachers want TSF assets invested in market investments. We endorse this position, as it would put the TSF on the same basis as private sector funds and has the potential to provide a greater investment risk return over the long term.

The OTF's position is that, "the primary purpose of the investment of the assets of the TSF (should) be to achieve the best possible returns within the bounds of prudent financial management so as to secure the benefits of plan participants."[12]

Teachers are opposed to concessionary investments by the TSF. We agree with this position.

Maintaining the Deal

No Linkage of Salary and Pension Benefits

Teachers are opposed to linking salary and pension benefit negotiations as they feel total compensation bargaining will not work in practice, given their desire for a common pension benefit system for all teachers, and the fact that collective bargaining for salaries is done on a school board by school board basis. Teachers want to retain the present "discussion" process for pensions.

While not strictly speaking a pension issue, we do not endorse this position.

Salary and pension benefit negotiations should be linked in a total compensation context. If this is not done, the taxpayer will continue to be the loser because decisions on total compensation are not made at the same time or by the same employer. We sympathize with the difficulties involved in making the link, but strongly urge that an appropriate linkage mechanism be sought.

Government statutory guarantee

Teachers want no change in the Government's statutory guarantee to fund any deficiency in the TSF. While we do not object to this, we cannot understand the value that some teachers place on this guarantee. In our view, the Government's covenant as employer/plan sponsor to pay the pension promised and the statutory guarantee amount to one and the same thing.

Separation of the TSF and TSAF

Teachers want no linkage between the TSF and TSAF at this time. They want issues relating to the TSAF addressed after issues relating to the TSF are resolved.

We do not endorse this position.

In our view, the inflation protection provided to teachers from the TSAF is directly related to the pension benefits provided by the TSF. To separate discussions on these two funds would ignore the fact that they are part of the same pension deal. We believe it is in the best interests of taxpayers and teachers to merge the two funds.

Employer Contribution Rates

Teachers want to retain matching employer and employee contributions.

We do not endorse this position unless teachers are also prepared to share equally the burden of any deficit. Matching contributions in the context of a defined benefit

[12] Ontario Teachers' Federation (OTF) Brief to Task Force on the Investment of Public Sector Pension Funds, March, 1987, p. 3.

related deal (where the employer bears the burden of any deficit) are unfair to the taxpayer.

It should be noted that where an employer has the right under a pension deal to vary his contribution rate, the Pension Benefits Act, 1987 may impose constraints on that right. Section 40 of that Act in effect requires that employer contributions plus any investment earnings thereon must add up to at least 50 per cent of the value of a plan member's pension in respect of years after 1986. However, this is not a requirement that the employer's contribution must at all times match or exceed the employees' contribution. The calculation required by Section 40 is based on the entire period of a plan member's employment.

Centralization of Pension Funds

Teachers want the TSF to remain independent of any other pension fund. Subject to our comments with respect to merging the TSAF with the TSF, we endorse this position.

See Chapter 4 for our comments on the issue of centralization vs. decentralization.

Summary

Figure 7.10 summarizes the teachers' comments and the Task Force's response.

Summary of Teachers' Comments and Task Force's Response

Teacher's Comments	Task Force Response	Comments
Teachers should own TSF surplus	Do not agree	Teachers do not share TSF deficit. Teachers may be entitled to share an actuarial surplus.
Teachers will share control of TSF provided government maintains statutory guarantee	Do not agree	Teachers do not share TSF deficit.
TSF should be invested in market investments	Agree	How TSF assets are invested is not a teacher decision. However, the change is desirable.
No link between salary and pension benefit negotiations.	Do not agree	Highly desirable that a direct link be forged in a total compensation context.
Government should continue to provide defined benefit and statutory guarantee.	Not opposed	Do not understand the value of the statutory guarantee, since it is the same as the pension promise.
Issues relating to the TSF should be resolved before addressing TSAF.	Do not agree	Both are part of the same pension deal. It is in the taxpayers' interest to merge them.
Matching employer and employee contributions should continue.	Agree if deal changed to a shared risk/reward deal.	Inconsistent with defined benefit related deal.
TSF should remain separate from other public sector pension funds.	Agree except for TSAF	Fund structure is not a teacher decision. Continued separation is desirable for other reasons.

FIGURE 7.10

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the teachers' pension deal if a contributory defined benefit related deal is retained.

Section IV introduces alternatives for a new pension deal.

A New Teachers' Superannuation Fund

As presently structured, the TSF is, for all intents and purposes, an integral part of the public accounts of Ontario. The fund is not established at arms length from either the employer/plan sponsor or the plan members. We believe that it should be.[13]

There are two main alternatives for structuring the TSF at arms length from the Government and teachers:

- Establish a common Board of Governors for the TSF and the TSC.
- Establish the TSF with its own Board of Governors, independent of the TSC.

The first alternative offers the advantage of having a common Board responsible for matters relating to both the assets (the TSF) and the liabilities (plan administration) of the teachers' pension deal.

A major difficulty with this alternative, however, is that the equal government/ teacher representation on the TSC is not appropriate for the TSF. Given that the employer for pension purposes has the obligation to pay for any deficit in the TSF, the Government should determine the organizational structure of the TSF and should appoint a majority of the Board of Governors.

It may be possible to overcome this difficulty. However, if a common TSF/TSC Board of Governors with appropriate representation is not possible, we recommend the alternative of establishing the TSF with its own Board of Governors.

Recommendation 7.1

The Teachers' Superannuation Fund be established at arms length from the Government and teachers, with its own board responsible for investment management and appointed by the Lieutenant Governor in Council. A minority of board members should be plan members or their representatives.

Establishing the TSF as an arms-length agency separate from the TSC raises two issues.

[13] See *Pension Fund Structure,* Research Report #2. This report identifies and assesses alternative structures for those pension funds which would be invested in market investments if the Task Force's recommendations are adopted.

First, the governors of the TSF will need to have an appreciation of the risk tolerance of the employers for pension purposes.

The second issue is the danger that any discussions between the TSF governors and the Government could be viewed as an opportunity for the Government to give political direction. The best antidote for such fears is to:

- appoint TSF governors of the highest quality and integrity
- ensure that the fiduciary responsibility of the TSF governors is well understood and enforced
- ensure that there is frequent and open communication about the decisions of the TSF governors.

Investment Policy: Market Investments

Periodically, the Government and the OTF have discussed the feasibility of investing the assets of, and future contributions to, the TSF in market investments. Diversification is the term often used to describe this shift in the TSF's investment policy.

For many teachers, the issue is: when and how, not whether, the TSF should be invested in market investments. We agree. See Chapter 5.

Recommendation 7.2

The TSF should be invested in market investments.

Since it will take time to make the legislative changes and establish an investment team, it is unlikely that such investment could begin in less than 18 months after a decision to proceed is made.

Recommendation 7.3

The net cash flow of the TSF should be invested in market investments beginning in 1989: 20 per cent in the first year, 50 per cent in the second year, and 100 per cent in the third and subsequent years.

Recommendation 7.4

Non-market government debentures held by the TSF should be re-invested in market investments as they mature.

We make similar recommendations with respect to the TSAF in Chapter 9.

If recommendations 7.2 to 7.4 were implemented without the phase-in period contained in Recommendation 7.3, the TSC estimates that approximately $18 billion, or about 60 per cent of the TSF, would be invested in market investments after 10

years. To put this into perspective, this would require the investment of approximately $7.5 million a day over a 10 year period.[14]

Investment Policy: Level of Risk

The current legislative requirement is that the TSF be invested in long-term, non-market government debentures. In effect, this is the TSF's investment policy.

It is a rigid investment policy with no particular relationship to the liabilities of the plan, and with no explicit decision on the appropriate level of investment risk.

Although investing in government debt is very secure (i.e. there is little or no risk of default), such investments are not risk free in a broader sense. For example, the return on long-term fixed income debt is not responsive to changes in inflation and therefore will not track liabilities if inflation rates change. Moreover, the assets of the TSF are non-marketable and so cannot be traded for other types of assets which might be more consistent with the nature of the liabilities of the TSF. These factors result in a sizeable risk that the assets of the TSF will not match the liabilities at any given time.

We believe that this investment policy is inappropriate and should be changed to one which maximizes the return to the TSF, at an appropriate level of risk.

Recommendation 7.5

Concurrent with a shift to market investments, the investment policy of the TSF should be changed to one which maximizes the return to the TSF at an appropriate level of risk.

Ownership of an Investment Risk Surplus

If the governors of the TSF adopt an investment policy that seeks to earn a return above the risk-free rate by incurring more risk, any additional return which results would be an investment risk surplus (see Chapter 3).

As noted in Chapter 5, if the funds currently invested in long-term, non-market government debentures had been invested in a diversified portfolio of market investments, the rate of return of TSF investments might have been 2 per cent higher over the past decade.

This should not be translated into an expectation that a shift to diversified market investments would earn 2 per cent more in the future. However, the Task Force is of the view that a diversified portfolio would likely achieve a higher rate of return without significantly increasing the level of risk.[15]

The current contributory defined benefit deal with its matching contributions allows plan members to share any surplus (including an investment risk surplus) without bearing the burden of any deficit.

[14] TSC Brief, p. 16.

[15] For a discussion of risk, see *Market vs. Non-Market Investments*, Research Report #4.

For a number of reasons, we believe that the taxpayer alone should benefit from any investment risk surplus. These reasons include:

- The taxpayer bears the burden of any deficit.
- The pensions of teachers are guaranteed by the Government.
- The pension promised to teachers is a defined benefit and there is no linkage between the investment performance of the assets in a fund for this type of plan and the pension benefit which has been promised.
- Teachers have argued that a major reason for deficits in the past was that the TSF did not earn a sufficient rate of return. The deficits which arose under this investment policy were borne by the taxpayer alone. By the same logic, an investment risk surplus due to a different investment policy should be to the credit of the taxpayer.
- Teachers' pensions are inflation indexed to the CPI up to a cap of 8 per cent with a carryover. As a result, teachers cannot claim that their pensions are payable in nominal rather than in real dollars.

Under the current pension deal, there is no effective way for the taxpayer to benefit directly from any investment risk surplus. The options which normally might be considered by an employer/plan sponsor to gain from an investment risk surplus and the practical difficulties of each, insofar as the teachers' pension deal is concerned, are as follows:

- surplus withdrawal: This is not permitted under the Teachers' Superannuation Act nor the present regulations under the Pension Benefits Act.
- reduce contributions of the employers for pension purposes (i.e. a variable employer contribution rate): This option conflicts with the fixed matching contributions prescribed in the Teachers' Superannuation Act.
- offset any liability of the employers for pension purposes to pay for a deficit: There is no deficit at present in the TSF, but one could arise in the future if the TSF and TSAF are merged.
- use the surplus to fund benefit improvements: This option would represent a gain to the taxpayer only if benefit improvements were planned and would have been paid for entirely by the Government regardless of whether there was a surplus or not.

Of these options, we feel that a variable employer contribution rate, providing the flexibility to reduce employer contributions as well as to make additional employer contributions, is the most appropriate.

Recommendation 7.6

If the taxpayer remains liable for any deficit in the TSF, the Government should seek to change the teachers' pension deal so that the taxpayer benefits from any investment risk surplus in the TSF.

We note that to the extent that an investment risk or actuarial surplus is not distributed, it provides a contingency reserve or cushion against future actuarial or investment risk deficits. In our view, it would be prudent to leave at least part of an

actuarial surplus or investment risk surplus in the TSF as a contingency reserve, since the $742 million surplus represented less than 8 per cent of the assets of the TSF as of December 31, 1986. A further consideration is the issue of the unfunded future obligations of the TSAF.

Ownership of an Actuarial Surplus

As discussed in Section II, teachers may be entitled to a share of an actuarial surplus to the extent that it resulted from their over-contributions due to conservative actuarial assumptions. The taxpayer should benefit from the remainder of any actuarial surplus.

While we are not able to determine who is entitled to what share of the existing actuarial surplus, this framework provides a basis for structuring assumptions and analysis so that ownership of a future actuarial surplus will be clear.

In order for the taxpayer to benefit from an actuarial surplus, however, greater flexibility will be required than is now permitted under the Teachers' Superannuation Act.

Recommendation 7.7

The Government should seek to change the teachers' pension deal so that:

- **teachers can benefit from that part of an actuarial surplus in the TSF that results from their over-contributions, and**
- **the taxpayer can benefit from the remainder of an actuarial surplus in the TSF.**

Merging the TSF and the TSAF

As presently structured, inflation indexing of teachers' pensions (in the TSAF) is separate from the basic pension promise (in the TSF). This is not appropriate as it hides the true cost of providing teachers' pension benefits from both teachers and the taxpayer.

The two obligations should be linked. See Chapter 9.

Recommendation 7.8

The Government should initiate discussions with the Ontario Teachers' Federation to begin the process of merging the assets and liabilities of the TSAF with the TSF.

It is emphasized that teachers' pension entitlements will not be affected by any of the Task Force's recommendations.

SECTION IV

A Possible New Pension Deal

This section suggests alternative ways to better balance the interests of teachers and taxpayers and to address the concerns of teachers, through a new kind of pension deal.

Figure 7.10 noted teachers' comments on their current pension deal and the Task Force's response. In our view, there is a wide gulf between what the teachers want and what is possible, given the nature of a defined benefit related deal.

There are other types of deals, however, which could satisfy some of the teachers' comments.

Figure 7.11 classifies the teachers' comments in terms of whether they are consistent with an asset related deal, a defined benefit related deal, a combined defined benefit/asset related deal or are independent of all three.

Teachers' Comments by Type of Pension Deal

Defined Benefit Related Deal	Combined Defined Benefit/ Asset Related Deal	Asset Related Deal	Independent
Government should continue to provide defined benefit and statutory guarantee.	Matching employer and employee contributions should continue.	Teachers should own TSF surplus.	No link between salary and pension benefit negotiations.
—	Teachers are willing to share control of TSF provided the government maintains statutory guarantee.	TSF should be invested in market investments (assuming that teachers own any resulting surplus).	TSF should remain separate from other public sector pension funds.
—	—	—	Issues relating to the TSF should be resolved before addressing TSAF.

FIGURE 7.11

Teachers appear to want the best features of both asset related and defined benefit related pension deals, and none of the risks of either. The fact that they support the matching contribution policy suggests that teachers also want elements of a combined deal.

As an alternative to the changes to the teachers' pension deal outlined in Section III, the Government could initiate discussions with the teachers to determine whether they would like to have a new kind of pension deal.

Any such discussions with teachers should focus on two basic options:

- a shared risk/reward deal where taxpayers and teachers share equally in any surplus or deficit and in decision-making. (This kind of pension deal is

consistent with the matching contribution approach contained in the current pension deal but, of course, other changes to the current deal would be required if a combined pension deal is desired.)

- a defined contribution deal where teachers have all of the investment reward and all of the investment risk and control decision-making.

Integration of the TSAF with the TSF would be an essential part of either option.

Recommendation 7.9

The Government should initiate discussions with teachers and their representatives to see if they wish to retain their current defined benefit related deal or have a new pension deal – for example, a shared risk/reward deal or a defined contribution deal.

SECTION V

Clarifying Government and School Board Roles

This section is directed to the Government, specifically to the Ministry of Education, in its capacity as the employer for pension purposes for teachers employed by school boards and school districts. The objective is to signal areas which will require special attention by the Ministry and changes to its present practices.

Most teachers have in effect two employers:

- school boards for salary and other terms and conditions of employment
- the Ministry of Education for pension purposes.[16]

The division of the role of employer between school boards and the Government may have a great deal of merit but it creates problems:

- first, the teachers' total compensation is not the responsibility of one employer, and
- second, the use of surplus for early retirement purposes tends to place the Province in a wider human resources role than that envisaged by its role as plan sponsor/contributor.

We believe that these problems should be explicitly addressed.

Recommendation 7.10

The Government should establish a direct and clear link between salary negotiations and pension benefit discussions so that the total compensation paid to teachers can be revealed to teachers and taxpayers alike and appropriate trade-offs considered in a more explicit way.

[16] The responsibility for teacher pensions has been recently transferred back to the Ministry of Education from the Ministry of Treasury and Economics. Treasury had this responsibility for three years and continues to exercise considerable influence over pension matters.

It is beyond our terms of reference to make recommendations outside the pension fund area on the role of the Province vis a vis teachers. However, we would be remiss if we did not observe that:

- Province-wide issues involving teachers cannot be adequately dealt with by the highly decentralized school board structure now in place. The fact that pensions for teachers are a Provincial responsibility is a case in point.
- The lack of a clear linkage between the local school board/teacher relationship and the Ministry of Education/teacher relationship is detrimental to the taxpayers' interests. Teachers' salaries and benefits must be viewed in a total compensation context.

  This observation is not a recommendation for the Ministry of Education to assume salary and pension benefit negotiation responsibility for teachers on a province-wide basis. There is much merit in education continuing to be a matter of local concern and control.
- Regardless of whether our recommendation for a shift to market invest ments and a new structure for the TSF, with its own Board, is accepted, the Ministry of Education will need to think very carefully about its role as employer for pension purposes within whatever pension deal is in force. The Ministry of Education must be prepared to bring to its role as the employer for pension purposes a mental discipline and toughness which appears to have been lacking in the past.
- As noted in Figure 7.3, the Ministry of Education and the school boards are not the only employers in the teachers' pension deal. A total of 123 private schools and 68 other employers such as community colleges also employ teachers who are plan members. While only about 2 or 3 per cent of plan members are involved, their interests and those of their employers must be taken into account.

Conclusion

This chapter assessed the current pension deal with Ontario's teachers and noted four problems. It discussed teachers' comments on the current pension deal and the Task Force's response. It recommended changes that should be made to the current defined benefit related deal and discusses alternative new deals.

Finally, it looked at the role of the Ministry of Education and the need for it to sharpen its perception of its responsibilities as the representative of the taxpayer.

CHAPTER 8

PUBLIC SERVICE SUPERANNUATION FUND (PSSF)

SYNOPSIS

The current public service pension deal should be changed. The OFL and OPSEU have proposed that a portion of the PSSF be invested in market investments to establish a market-related rate of return for all future investments. They have also proposed that any surpluses be used to improve benefits and membership coverage. The Task Force believes that the PSSF should be in market investments. However, under the present pension deal, any investment risk surplus should benefit the taxpayer, since the taxpayer is required to make up any deficit in the PSSF. The PSSF should have its own independent board of governors, including a minority of plan members. Public servants may prefer to replace their current defined benefit related deal with a shared risk/reward or a defined contribution deal.

Introduction

This chapter reviews the current pension deal with public servants, the changes public servants and their representatives want and the implications of those changes. It also recommends changes to the current pension deal, and discusses alternatives for a new kind of pension deal for public servants.

Figure 8.1 provides an overview of the PSSF.

Overview of the PSSF

December 31, 1986

Fund	Sector	Assets * ($Billion)	Rank by Assets	Employers	Active Plan Members	Beneficiaries	1986** Cash Flow ($Million)	*** Surplus (Deficit) ($ Million)
PSSF	Government	4.0	3	33	77,294	23,742	533	110

* Book value. The imputed market value is $4.77 billion. This amount does not include the public servants' portion of the SAF. See Chapter 9.

** For the fiscal year April 1, 1986 to March 31, 1987.

*** Actuarial valuation as of December 31, 1985.

FIGURE 8.1

The PSSF is Ontario's third largest public sector pension fund with assets at book value of over $4 billion as at December 31, 1986.[1] The Province is the plan sponsor and the principal employer/contributor to the fund.[2] There are over 77,000 active plan members and almost 24,000 plan beneficiaries. Cash flow in fiscal year 1986/87 was $533 million. The PSSF had a surplus of $110 million as at December 31, 1985.

Between 70 and 75 per cent of public servants are represented by the Ontario Public Service Employees Union (OPSEU).

The chapter is divided into four sections:

I. **The pension deal**

II. **Public servants' views**

III. **Changes needed to the pension deal**

IV. **A possible new pension deal.**

SECTION I

The Pension Deal

Roles of Participants

The public servants' pension deal is set out in the Public Service Superannuation Act and the Superannuation Adjustment Benefits Act.[3]

Figure 8.2 summarizes the roles and responsibilities of the various parties to the public servants' pension deal.

PSSF Roles and Responsibilities

Sponsor	Employer *	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
Province	Province and Various Boards and Commissions	Province and Various Boards and Commissions	Treasurer	None Desig-nated	Legislature	Treasurer (limited role)

* The Province also guarantees the pension promise.

FIGURE 8.2

[1] This figure is the same as the fiscal year-end figure at March 31, 1986. Book value as of March 31, 1987 was $4,563 million.

[2] Thirty-two agencies and commissions also contribute as employers to the PSSF. See Appendix N.

[3] See Chapter 9 for a description of the components of the public servants' pension deal set out in the Superannuation Adjustment Benefits Act.

The Province of Ontario is the plan sponsor and the employer of most plan members. Thirty-two Provincial boards and commissions and their employees also participate in the plan.

Each employer pays his contributions into the PSSF. In the case of the Province this is a notional, or bookkeeping, contribution only.

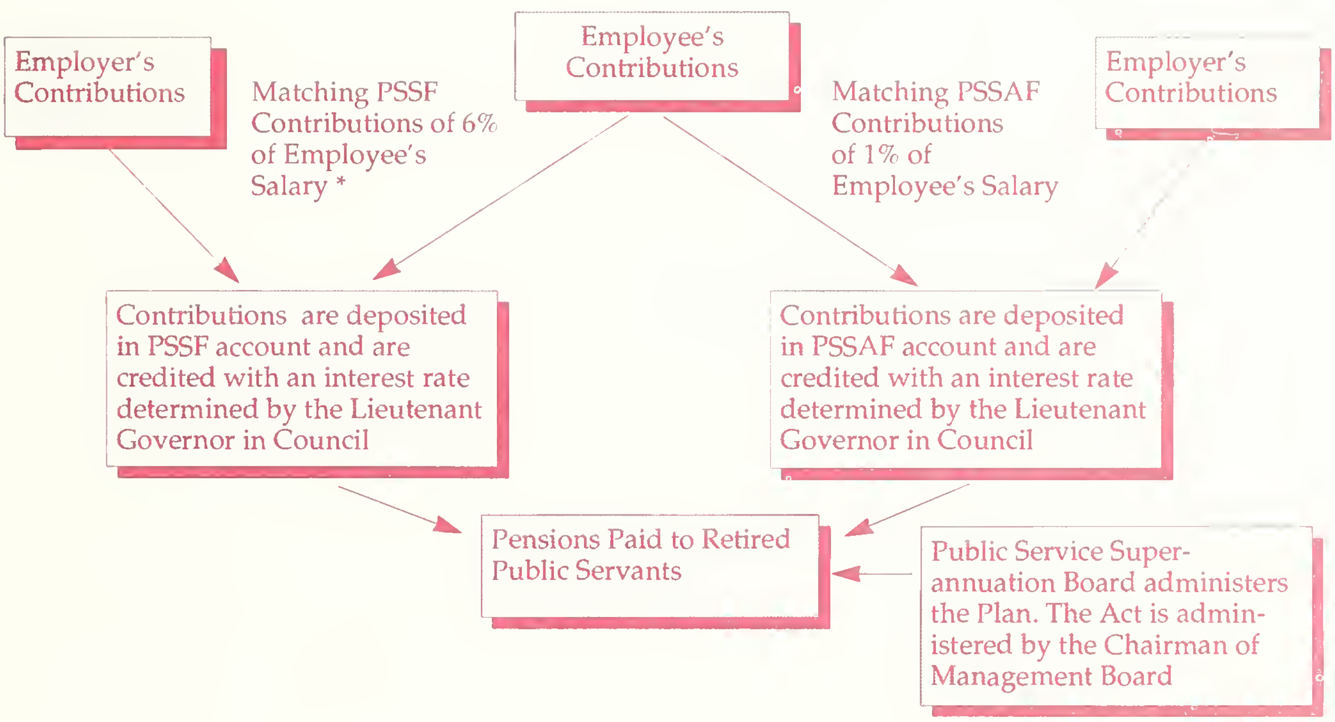
The Treasurer of Ontario is the custodian of the PSSF. No trustee has been appointed. The Legislature has determined how the assets of the PSSF are to be invested and so is the investment policy maker.

The legislation requires that PSSF funds be deposited in the accounts of the Province, and interest credited on such deposits at the close of each fiscal year at such rate and in such manner as the Lieutenant Governor in Council determines from time to time (on the advice of the Treasurer). Once the interest rate and terms of the deposits have been decided, there is no discretionary investment management because the assets of the PSSF are non-marketable.

Relationship of the Participants

Figure 8.3 illustrates the relationship among the various parties involved in the PSSF and the PSSAF.

PSSF Structure and Decision-Making Relationships



* Contributions to the PSSF are approximately 6 per cent of salary, less contributions to the CPP on CPP contributory earnings (up to $25,900 in 1987).

FIGURE 8.3

The Chairman of Management Board administers the Public Service Superannuation Act and the Superannuation Adjustment Benefits Act.[4] The Public Service Superannuation Board (PSSB) makes recommendations to the Chairman of Management Board on matters related to the Act. The PSSB has four members appointed by the Lieutenant Governor in Council, one of whom must be a representative of the Civil Service Commission and one of whom must be a representative of OPSEU. The Chairman is designated by the Lieutenant Governor in Council.

Growth of the PSSF

The growth of the PSSF since 1965 is illustrated in Figure 8.4.

Growth of the PSSF ~ 1965 - 1986

Year	Assets * ($ Billion)	Active Plan Members	Annual Contributions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1965	0.2	41,432	36	3,118	13
1975	0.8	74,528	84	10,523	31
1980	1.8	78,721	134	14,321	89
1986	4.0	77,294	238	23,700	192

* Book value

FIGURE 8.4

Since 1965, the book value of PSSF assets has increased by over 20 times, the number of active plan members has almost doubled, the number of beneficiaries has increased by almost seven times and the annual pension benefits paid have increased by almost 15 times.

Record of Surpluses and Deficits and Employer Contribution Rates

Figure 8.5 illustrates the record of surpluses and deficits in the PSSF since 1976, and the employer contributions as a percentage of employee contributions each year over the same period.

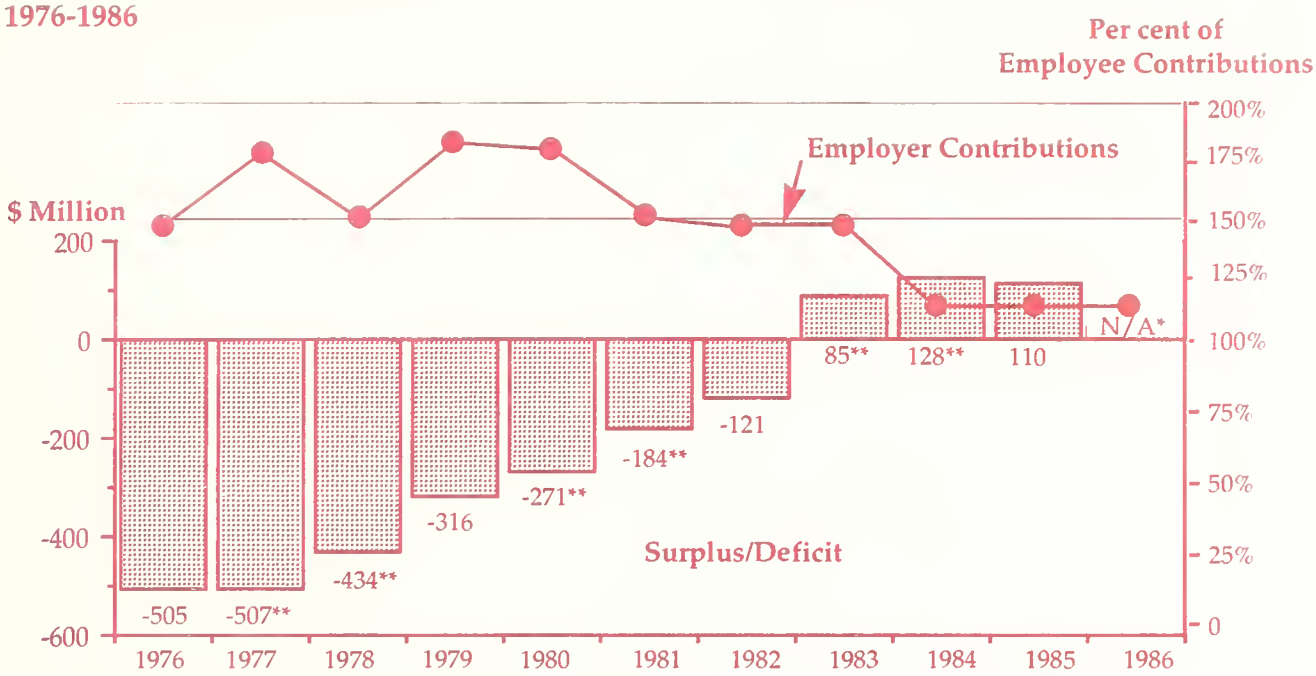
The PSSF had a deficit of $505 million in 1976, which dropped gradually until the first formal surplus – $110 million – arose in the December 31, 1985 actuarial valuation.[5] Because of the requirement to make additional payments to the PSSF in light of this deficit, employer contributions exceeded employee contributions between 1976 and 1985, peaking at 187 per cent in 1979. The last unfunded liability

[4] The public servants' portion of the SAF is known as the Public Service Superannuation Adjustment Fund (PSSAF).

[5] Triennial valuations were carried out by the PSSF actuary as of December 31 in the years 1976, 1979, 1982 and 1985. These were official valuations which were filed with the Pension Commission of Ontario. In the intervening years, interim valuations were prepared by the PSSF actuary for internal monitoring purposes. The PSSF therefore did not show a formal surplus until 1985.

Comparison of the PSSF Surplus (Deficit) and the Employer Contributions as a Percentage of Public Servant Contributions

1976-1986



* 1986 actuarial valuation not available
** Informal interim valuations

Source: Public Sector Pensions Advisory Board Staff and Human Resources Secretariat

FIGURE 8.5

payment was made on January 1, 1986, in respect of 1985. The employer's contribution ratio for 1987 therefore should be close to 100 per cent, apart from minor adjustments such as withdrawals.

Investment Management

The Public Service Superannuation Act requires that PSSF assets not required for current expenditures be invested in non-market government debt in the form of deposits in the accounts of the Province.

The Act does not specify how the interest rate and term of the debt are to be determined, stating only that interest shall be credited at the close of each fiscal year at a rate and in a manner to be determined from time to time by the Lieutenant Governor in Council.

The Act requires the Treasurer to keep records showing a separate account for each contributor to the Fund.

The PSSF currently holds 13.0 per cent of Ontario's debt incurred for the Province's own purposes.[6]

[6] See Figure 1.12 in Chapter 1.

Formal Pension Deal vs Current Practice

Figure 8.6 compares the formal pension deal for public servants with current practice and identifies areas of difference (represented by the shaded areas).

PSSF ~ Formal Pension Deal

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit *	2% per year of service based on best 5 years + inflation	Fixed matching contributions + government guarantee	Surplus: not stated Deficit: employer	Non-market government debt (trust account)	Plan Administration: partially shared Investment Management: Treasurer (limited role)	Legislation

*See "Problems with the Formal Pension Deal" below.

PSSF ~ Current Practice

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit	2% per year of service based on best 5 years + inflation	Fixed matching contributions + government guarantee	Surplus: No Distribution Deficit: employer	Non-market government debt (trust account)	Plan Administration: partially shared Investment Management: Treasurer (limited role)	Legislation and Formal discussion

FIGURE 8.6

The formal pension deal with public servants can be summarized as follows:

- The pension deal is nominally a defined benefit related deal.
- The pension benefit is determined by a formula based on a combination of years of service and the average salary earned in the best five years of service.
- Inflation protection is provided through the PSSAF (see Chapter 9) largely on a pay-as-you-go basis. The PSSF benefit is automatically indexed to the CPI up to a cap of 8 per cent, with a carryover for any CPI increase above 8 per cent.
- The Province is the plan sponsor and the employer of most of the plan members.
- The Province guarantees the pension promise in that, if the PSSF is insufficient to meet the pension benefits promised, the deficiency will be made up from the Consolidated Revenue Fund.
- The employers (including the Government) and the public servants make fixed matching contributions to both the PSSF and the PSSAF.
- The employers are responsible for any deficit.

- Who owns a surplus is not stated.
- Changing the pension deal requires a change to the Public Service Superannuation Act and/or the Superannuation Adjustment Benefits Act.
- Investment policy is set by legislation. The PSSF is required to invest in non-market government debt.
- There is no discretionary investment management because the assets of the PSSF are non-marketable. The Treasurer sets the initial interest rate and term of the deposits, subject to the approval of the Lieutenant Governor in Council.
- Plan administration is shared through the PSSB.
- Collective bargaining for pension benefits is prohibited by legislation. Any changes to the pension deal require changes to the Public Service Superannuation Act or the Superannuation Adjustment Benefits Act.

Current practice differs from the formal pension deal only in that, while collective bargaining for pensions is prohibited under the Crown Employees' Collective Bargaining Act, there have been discussions – informal in the past and now formal – between OPSEU and the Government over pension benefits and other aspects of the pension deal.

Problems with the Formal Pension Deal

The formal pension deal is difficult to classify. While it is nominally a contributory defined benefit related deal, and the employers are responsible for any deficit, the fact that there are matching employer and employee contributions is more consistent with a combined defined benefit/asset related deal.

In addition, there are a number of problems with the formal pension deal:

- First, there is a lack of clarity with respect to who owns a surplus. The employers bear the burden of any deficit, but the deal is silent on who benefits from any surplus. As the PSSF moved from deficit to surplus as of December 31, 1985, the employers' obligations with respect to prior unfunded liabilities were eliminated. There has been no distribution of the surplus.
- Second, decisions relating to the PSSAF formally are made independently of decisions relating to the PSSF even though both are part of the public servants' pension deal. Representatives of employers and employees are aware of the interdependence of the PSSAF and PSSF but are constrained by the formal separation.
- Third, future liabilities relating to the PSSAF are not being funded on an on-going basis as they are in the PSSF. Currently, the PSSF has a small surplus while the PSSAF, if it were being funded like the PSSF, would have a large deficit. As a result, future liabilities of the PSSAF with respect to current public servants are being passed on to future generations of public servants and taxpayers.

SECTION II

Public Servants' Views

This section reviews comments received from the OFL and from some public servants, and the Task Force's response.

The OFL brief was made in conjunction with four affiliates including the Ontario Public Service Employees Union (OPSEU), which represents public servants in the bargaining unit, and the Ontario Liquor Board Employees Union (OLBEU).

The comments received from the OFL for the most part were not directed specifically at the PSSF. As a result, we have exercised judgement in relating the OFL's comments to the PSSF.

We did not receive a brief from Management Board but we did have discussions with staff of the Human Resources Secretariat of Management Board.

The comments received from the OFL and individual public servants fall into two categories:

- those advocating changes in certain aspects of the deal:
  - ownership of a surplus (deficit)
  - pension fund structure and control
  - investment policy
  - total compensation
  - merging the PSSF and PSSAF
- those advocating maintaining aspects of the deal:
  - employer guarantee of defined benefit
  - Government statutory guarantee
  - employer contribution rates
  - centralization of pension funds

Changing the Deal

Ownership of a Surplus (Deficit)

The OFL and some public servants believe that any surplus in a pension fund (including the PSSF) should be used to improve the benefits of plan members and to extend coverage to other workers. The OFL is opposed to using a surplus to reduce contribution rates even if it were the employees who were to benefit in the form of a contribution holiday.[7]

Except as noted below, we do not endorse this position with respect to pension funds in general or the PSSF in particular.

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[7] OFL Brief, page 20.

In Chapter 3, we advanced the proposition that a surplus can have two parts:

- an investment risk surplus, and
- an actuarial surplus.[8]

This distinction is useful in thinking through which party or parties may be entitled to which parts of a surplus, although the assumptions underlying an existing actuarial surplus may not have been structured so as to assist in allocating it.

There is a plausible argument, particularly in the context of a contributory defined benefit pension deal with matching contributions (such as the public service deal), that plan members may be entitled to a share of an actuarial surplus. This argument is based on the view that, if employee contribution rates are determined, explicitly or implicitly, on the basis of conservative (as opposed to best estimate) actuarial assumptions, leading to an actuarial surplus, employees are entitled to that part of the actuarial surplus that results from their over-contributions.

We believe that a large part of the PSSF surplus is an actuarial surplus. Our rationale is that:

- The long term rate of return assumed by the actuary was essentially equivalent to a risk free rate of return (i.e. approximately 2 per cent real).
- The employer and public servant contribution rates of 6.0 per cent each are considered necessary to fully fund the PSSF.
- The actual rate of return of an essentially risk-free investment such as Treasury Bills over the past few years has been higher than the actuarial interest assumption for the PSSF.

However, we are not in a position to identify what portion of the $110 million surplus in the PSSF as of December 31, 1985 is an actuarial surplus. Nor can we determine whether any of that actuarial surplus resulted from over-contributions by public servants on the basis of conservative actuarial assumptions.

In addition to the actuarial surplus, we also believe that part of the PSSF surplus since 1985 is an investment risk surplus. Our rationale is that the employer has taken additional risk above a risk-free rate of return, by investing in a portfolio exclusively made up of long term, non-market debt. The additional return above the risk-free level from these investments has led to an investment risk surplus. This investment risk surplus should be to the benefit of the employer (i.e. the taxpayer).

This leaves unanswered the question: who should be responsible for an actuarial deficit if the actuarial assumptions are wrong?

Some union representatives have argued that history shows there is a much greater chance of there being an actuarial surplus than a deficit because actuaries use very conservative assumptions. This is another way of arguing that an employee's contribution rate is usually set too high.

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[8] An investment risk surplus (or deficit) results from adopting an investment policy with a level of risk above that related to an investment policy that is essentially risk free.

An actuarial surplus is the remainder of any surplus and results from actual experience being better than the actuary assumed.

While, as noted earlier, this argument may be correct, history also shows that employers have had to make considerable extra payments to cover deficits which arose, at least in part, because actuarial assumptions were wrong (i.e. experience deficiencies). See Figure 8.5.

The responsibility for such deficits in a defined benefit related deal rests with the employer and, in our view, should continue to do so.

Pension Fund Structure and Control

The OFL states that, "the minimum position acceptable . . . is joint trusteeship in any pension plans where the unions so desire."[9] We do not endorse this position.

We believe that some plan member participation in the PSSF is appropriate. However, so long as the employer/plan sponsor has explicit liability for any deficit, particularly an investment risk deficit, we believe the employer should control investment decisions.

The OFL also recommend that, where a Board of Trustees does not exist, as in the case of the PSSF, such a board should be constituted. We endorse this position where it is practical.

Investment Policy

The OFL believes that "the inadequacy of the PSSF's overall rate of return . . . arises not from being cheated on the interest rate for provincial debt but from the Fund being confined to a non-diversified portfolio".[10]

The OFL says that the lower rate of return to the PSSF, renders "more difficult the process of achieving improvements in benefits and defending existing benefit levels against ill-informed and self serving criticism".[11]

As a result, the OFL proposes that 10 per cent of the PSSF be invested in market investments in order to determine a market rate of return to be applied to the remainder of net cash flow available for investment each year, even if these monies are borrowed by the Province.[12]

We agree with the principle of market determined rates of return advocated by the OFL. However, for the reasons set out in Chapter 5, we are of the view that ultimately all PSSF assets should be invested in market investments.

The OFL makes two proposals with respect to investment policy in general:

- First, it argues that ethical and social objectives can and should be pursued without impairing either the security or the earnings of pension funds, provided the objectives are those of plan members. It urges that the fiduciary responsibilities of pension fund trustees should be defined in legislation so as to provide for this. We deal with this topic in Chapter 5.

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[9] OFL Brief, page 25.

[10] OFL Brief, page, 22.

[11] OFL Brief, page, 23.

[12] Since receiving the OFL brief, the Task Force was advised on August 24, 1987 that OPSEU would not object to 100 per cent of the PSSF assets being invested in the capital market.

- Secondly, it proposes that the Government establish new investment vehicles, with competitive interest rates and government guarantees, as vehicles for pension funds to make social investments such as loans for non-profit housing co-operatives or new manufacturing in Northern Ontario.[13]

  As noted in Chapter 5, we believe that, where the Government wants to attract pension fund investments to areas of social policy priority, it should provide incentives or guarantees to ensure such investments will be competitive. Pension fund investments in such areas should be voluntary, not directed by the Government.

Total Compensation

The OFL urges linking salary and pension benefit negotiations as they feel total compensation bargaining is a desirable goal. Provided total compensation bargaining can be achieved outside of an arbitration process in the event of a deadlock, we endorse this position.

Merging the PSSF and PSSAF

The OFL and OPSEU are prepared to consider a merger of the PSSF and the PSSAF provided that such a merger is negotiated, not imposed by the Government.[14]. Individual public servants did not comment on this issue. We endorse a merger.

In our view, the inflation protection provided to public servants from the PSSAF is directly related to the pension benefits provided by the PSSF. To separate discussions on these two funds would ignore the fact that they are part of the same pension deal. It would be in the best interests of taxpayers and public servants to merge the two funds.

Maintaining the Deal

Employer Guarantee of Defined Benefit

The OFL favours defined benefit plans (as opposed to defined contribution plans) because it believes the employer has a higher tolerance for risk than do the plan members. In the OFL's view, the employer should guarantee the pension promise and pay for any deficit in the pension fund but not have access to any pension fund surplus, no matter how derived.

The OFL states that a pension deal of this kind is "just good public policy." Indeed, even if collective bargaining for pensions were possible for public servants and the union was unable to produce this kind of deal through negotiations, the OFL says that legislative remedies would be the logical next step.[15]

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[13] OFL Brief, page 31-33.

[14] Based on a meeting with the OFL, August 21, 1987.

[15] Based on a meeting with the OFL, August 21, 1987.

The Task Force does not endorse the OFL's position. Among other things, the OFL position ignores two essential points:

- whether an individual employee does or does not have a higher tolerance for risk than the individual taxpayer has not been demonstrated.
- even if it is true that taxpayers, either individually or collectively, have a higher tolerance for risk, it does not follow that taxpayers should be asked to bear a disproportionate amount of risk.

Public policy may ultimately support the OFL's point of view. Before it does, we would point out the very high cost to the taxpayer if such a policy is applied to public sector pension plans.

Government Statutory Guarantee

Although not addressed explicitly in briefs from public servants, the Task Force concludes from comments made to it by OPSEU that public servants want no change in the Government's statutory guarantee to fund any deficit in the PSSF. We are not opposed, although we cannot understand the value placed on this guarantee. In our view, the Government's covenant as employer/plan sponsor to pay the pension promised and the statutory guarantee amount to one and the same thing.

Employer Contribution Rates

The OFL is opposed to any change in the matching contribution policy. "In no event should employer contributions ever be allowed to fall below employee contributions when the plan is contributory."[16]

Even though the Public Service Superannuation Act requires matching contributions plus employer liability for a deficit, we do not endorse this position unless public servants are also prepared to share equally the burden of any deficit. Matching contributions in the context of a defined benefit related deal (where the employer bears the burden of any deficit) are unfair to the taxpayer.

It should be noted that where an employer has the right under a pension deal to vary his contribution rate, the Pension Benefits Act, 1987 may impose constraints on that right. Section 40 of that Act in effect requires that employer contributions plus any investment earnings thereon must add up to at least 50 per cent of the value of a plan member's pension in respect of years after 1986. However, this is not a requirement that the employer's contribution must at all times match or exceed the employees' contribution. The calculation required by Section 40 is based on the entire period of a plan member's employment.

Centralization of Pension Funds

The OFL and its affiliates are totally opposed to further centralization of public sector pension funds. Subject to our comments with respect to merging the PSSAF with the PSSF, we endorse this position.

See Chapter 4 for our comments on the issue of centralization vs. decentralization.

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[16] OFL Brief, page 20.

Summary

Figure 8.7 summarizes the public servants' comments and the Task Force's response.

Summary of OFL's and Public Servants' Comments and Task Force's Response

OFL and Public Servants' Comments	Task Force Response	Comments
Public servants should own PSSF surplus.	Do not agree	Public servants do not share PSSF deficit. Public servants may be entitled to share an actuarial surplus.
Public servants should have at least 50% control of PSSF.	Do not agree	Public servants do not share 50% of PSSF deficit.
PSSF should be invested in market investment (option of 10% in market).	Agree (Do not agree with 10% option)	How PSSF assets are invested is not a plan member decision. However, the change is desirable.
Salary and pension benefits should be negotiated within a total compensation context.	Agree	Formal discussions are now held between OPSEU & Management Board on pension matters. Pensions are not negotiable.
Government should continue to provide statutory guarantee.	Not opposed	Do not understand the value of the guarantee, since it is the same as the pension promise.
Employers should guarantee defined benefit.	Not opposed	Consistent with current deal, but not with matching contributions.
Plan members' social objectives should be pursued when consistent with the security and earnings of the PSSF.	Do not agree	It is a decision for the pension fund governors.
Merge the PSSF and PSSAF.	Agree	Both are part of the same pension deal. It is in the taxpayers' interest to merge them.
Matching employer and employee contributions should continue.	Agree if deal is changed to a shared risk/reward deal.	Inconsistent with defined benefit related deal.
PSSF should remain separate from other public sector pension funds.	Agree except for PSSAF	Fund structure is not a plan member decision. However, separation is desirable for other reasons.

FIGURE 8.7

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the pension deal for the public service if a contributory defined benefit related deal is retained.

Section IV introduces alternatives for a new pension deal.

A New Public Service Superannuation Fund

As presently structured, the PSSF is, for all intents and purposes, an integral part of the public accounts of Ontario. There is no trustee and the fund is not established at arms length from either the employer/plan sponsor or the plan members. We believe that it should be.[17]

Given the current pension deal and the employer/plan sponsor's liability for any deficit, the Government should determine the PSSF organizational structure and appoint the PSSF governors.

Recommendation 8.1

The PSSF be established at arms length from the Government and public servants, with its own board responsible for investment management and appointed by the Lieutenant Governor in Council. A minority of board members should be plan members or their representatives.

Establishing the PSSF as an arms length agency raises two issues.

First, the governors of the PSSF will need to have an appreciation of the risk tolerance of the employers.

The second issue is the danger that any discussions between the PSSF governors and the Government could be viewed as an opportunity for the Government to give political direction. There will always be those who will fear the worst. The best antidote for such fears is to:

- appoint PSSF governors of the highest quality and integrity
- ensure that the fiduciary responsibility of the PSSF governors is well understood and enforced
- ensure that there is frequent and open communication about the decisions of the PSSF governors.

Another issue to be addressed is the relationship of the PSSF to the Public Service Superannuation Board (PSSB). As presently constituted the PSSB has four members, three civil servants and an employee of the Ontario Public Service Employees Union (OPSEU). The Board approves disability and certain survivor

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[17] See *Pension Fund Structure*, Research Report #2. This report identifies and assesses alternative structures for those pension funds which would be invested in market investments if the Task Force's recommendations are adopted.

pension benefits. It evaluates eligibility in special cases and hears appeals against routine decisions made by the Employee Benefits and Data Services Branch of the Ministry of Government Services. It also advises the Minister on Public Service Superannuation Fund matters. The cost of administration support for the operation of the PSSB is paid for by the Employee Benefits and Data Services Branch of the Ministry of Government Services.

There are two main relationship options:

- First, the responsibilities of the PSSB and the PSSF could be assumed by a single arms-length agency similar to OMERS but without responsibility for benefits policy and funding policy.
- Second, the PSSB and the PSSF could remain separate entities.

In our view, either alternative is practical. While we make no recommendation on the relationship between PSSB and the PSSF, there is considerable merit in the same Board having responsibility for managing both pension plan assets and liabilities.

However, if the responsibilities of the PSSB and PSSF are assumed by a single Board, the membership of that Board should be determined by the kind of pension deal in force. In other words, if the present defined benefit deal continues, plan members should have minority representation.

Investment Policy: Market Investments

The current investment policy requires PSSF contributions and interest (net of expenses) to be deposited into the PSSF (i.e. invested in long-term, non-market government debt). That policy creates a long term, fixed income portfolio, with a lower rate of return than a diversified portfolio would provide.

As noted in Chapter 5, we support investing the PSSF in the capital market.

See Chapter 5, Section IV, for an explanation of the effect on the Province's finances of investing the cash flow of the PSSF in the capital market. In brief, if all the PSSF cash flow were invested in market investments, the Province's annual net cash requirements would rise by about $500 million. Such a change in accounting treatment, of course, would not change the Province's underlying financial position as measured by the budgetary deficit and the operating deficit.

Recommendation 8.2

The PSSF should be invested in market investments.

Since it will take time to make the legislative changes and establish an investment team, it is unlikely that such investment could begin in less than 18 months after a decision to proceed is made.

Recommendation 8.3

The net cash flow of the PSSF should be invested in market investments beginning in 1989: 20 per cent in the first year; 50 per cent in the second year; 100 per cent in the third and subsequent years.

Recommendation 8.4

Non-market government debt held by the PSSF should be reinvested in market investments as it matures.

We make similar recommendations with respect to the PSSAF in Chapter 9.

Investment Policy: Level of Risk

The current legislative requirement is that the PSSF be invested in long term, non-market government debt. In effect, this is the PSSF's investment policy.

It is a rigid investment policy with no particular relationship to the liabilities of the plan and with no explicit decision on the appropriate level of investment risk.

Although investing in government debt is very secure (i.e. there is little or no risk of default), such investments are not risk free to a pension fund in a broader sense. For example, the return on long-term fixed income debt is not responsive to changes in inflation and therefore will not track liabilities if inflation rates change. Moreover, the assets of the PSSF are non-marketable and so cannot be traded for other types of assets which might be more consistent with the nature of the liabilities of the PSSF. These factors result in a sizeable risk that the assets of the PSSF will not match the liabilities at any given time.

We believe that this investment policy is inappropriate and should be changed to one which maximizes the return to the PSSF, at an appropriate level of risk.

Recommendation 8.5

Concurrent with a shift to market investments, the investment policy of the PSSF should be changed to one which maximizes the return to the PSSF at an appropriate level of risk.

Ownership of an Investment Risk Surplus

If the governors of the PSSF adopt an investment policy that seeks to earn a rate of return above the risk-free rate by incurring more risk, any additional return which results would be an investment risk surplus (see Chapter 3).

As noted in Chapter 5, if the funds currently invested in long-term, non-market government debt had been invested in a diversified portfolio of market investments, the rate of return of PSSF investments might have been 2 per cent higher over the past decade. This should not be translated into an expectation that a shift to diversified market investments would earn 2 per cent more in the future.

However, the Task Force is of the view that a diversified portfolio would likely achieve a higher rate of return without significantly increasing the level of risk.[18]

[18] For a discussion of risk, see *Market vs. Non-Market Investments*, Research Report #4.

The current contributory defined benefit deal with its matching contributions allows plan members to share any surplus (including an investment risk surplus) without bearing the burden of any deficit.

For a number of reasons, we believe that the taxpayer alone should benefit from any investment risk surplus. These reasons include:

- The taxpayer bears the burden of any deficit.
- The pensions of public servants are guaranteed by the Government.
- The pension promised to public servants is a defined benefit and there is no linkage between the investment performance of a fund for this type of plan and the pension benefit which has been promised.
- The OFL argues that the current investment policy does not result in a sufficient rate of return. The deficits which arose under this investment policy were borne by the taxpayer alone. By the same logic, an investment surplus due to a different investment policy should be to the credit of the taxpayer.
- Public servants' pensions are indexed to inflation up to 8 per cent of the CPI. As a result, public servants cannot argue their pensions are payable in nominal rather than in real dollars.

Under the current pension deal, there is no effective way for the taxpayer to benefit directly from any investment risk surplus. The options which normally might be considered by an employer/plan sponsor to gain from an investment risk surplus and the practical difficulties of each, insofar as the public servants' pension deal is concerned, are as follows:

- surplus withdrawal: This is not permitted under the Public Service Superannuation Act nor the present regulations under the Pension Benefits Act.
- reduce contributions of the employers (i.e. a variable employer contribution rate): This option conflicts with the fixed matching contributions prescribed in the Public Service Superannuation Act.
- offset any liability of the employers for pension purposes to pay for a deficit: There is no deficit at present in the PSSF, but one could arise in the future if the PSSF and PSSAF are merged.
- use the surplus to fund benefit improvements: This option would represent a gain to the taxpayer only if benefit improvements were planned and would have been paid for entirely by the Government regardless of whether there was a surplus or not.

Of these options, we feel that a variable employer contribution rate, providing the flexibility to reduce employer contributions as well as to make additional employer contributions, is the most appropriate.

Recommendation 8.6

If the taxpayer remains liable for any deficit in the PSSF, the Government should seek to change the public service pension deal so that the taxpayer benefits from any investment risk surplus in the PSSF.

We note that to the extent a surplus is not distributed, it provides a contingency reserve or cushion against future actuarial or investment risk deficits. In our view, it would be prudent to leave at least part of any actuarial surplus or investment risk surplus in the PSSF as a contingency reserve, since the $110 million surplus represented less than 3 per cent of the assets of the PSSF as of December 31, 1986. A further consideration is the issue of the unfunded future obligations of the PSSAF.

Ownership of an Actuarial Surplus

As discussed in Section II, public servants may be entitled to a share of an actuarial surplus to the extent that it resulted from their over-contributions due to conservative actuarial assumptions. The taxpayer should benefit from the remainder of any actuarial surplus.

While we are not able to determine who is entitled to what share of the existing actuarial surplus, this framework provides a basis for structuring assumptions and analysis so that ownership of a future actuarial surplus will be clear.

In order for the taxpayer to benefit from an actuarial surplus, however, greater flexibility will be required than is now permitted under the Public Service Superannuation Act.

Recommendation 8.7

The Government should seek to change the public servants' pension deal so that:

- **public servants can benefit from that part of an actuarial surplus in the PSSF that results from their over-contributions, and**
- **the taxpayer can benefit from the remainder of an actuarial surplus in the PSSF.**

Merging the PSSF and the PSSAF

As presently structured, inflation indexing of public servants' pensions (in the PSSAF) is separate from the basic pension promise (in the PSSF). This is not appropriate as it hides the true cost of providing public servants' pension benefits from both public servants and the taxpayer.

The two obligations should be linked. See Chapter 9.

Recommendation 8.8

The Government should initiate discussions with public servants and their representatives to begin the process of merging the assets and liabilities of the PSSAF with the PSSF.

Total Compensation

The process for changing the benefit component of the pension deal does not link the cost of the pension promise with salary and indirect compensation costs. Because the components of a total compensation package are not decided at the same time, appropriate trade-offs are not made by the two parties.

Recommendation 8.9

The Government should establish a direct and clear link between salary decisions and pension benefit decisions so that the total compensation paid to public servants can be revealed to public servants and taxpayers alike, and appropriate trade-offs can be considered in a more explicit way.

It is emphasized that public servants' pension benefits will not be affected by the Task Force's recommendations.

SECTION IV

A Possible New Pension Deal

This section suggests alternative ways to better balance the interests of public servants and the taxpayer and to address the concerns raised by representatives of public servants, through a new kind of pension deal.

Figure 8.7 noted the comments of public servants and their representatives on their current pension deal and the Task Force's response. In our view, there is a wide gulf between what public servants want and what is possible, given the nature of a defined benefit related deal.

There are other types of deals, however, which could satisfy some of the public servants' comments.

Figure 8.8 classifies the comments of public servants and their representatives in terms of whether they are consistent with an asset related deal, a defined benefit related deal, a combined defined benefit/asset related deal or are independent of all three.

Public servants appear, as do the teachers, to want all the best features of both asset related and defined benefit related pension deals, and none of the risks of either. The fact that they support the matching contribution policy suggests that they also want elements of a combined deal.

OFL and Public Servants' Comments by Type of Pension Deal

Defined Benefit Related Deal	Combined Defined Benefit/ Asset Related Deal	Asset Related Deal	Independent
Government should continue to provide defined benefit and statutory guarantee	Matching employer and employee contributions should continue	Public servants should own PSSF surplus	Merge the PSSF and PSSAF
—	Public servants should have at least 50% control of PSSF	PSSF should be invested in market investments (Assuming that public servants own any resulting surplus)	PSSF should remain separate from other public sector pension funds
—	—	—	Salary and pension benefits should be negotiated within total compensation context

FIGURE 8.8

As an alternative to the changes to the public servants' pension deal as outlined in Section III, the Government could initiate discussions with public servants to determine whether they would like to have an entirely new kind of pension deal.

Any such discussions with public servants should focus on two basic options:

- a shared risk/reward deal where the taxpayers and public servants share equally in any surplus or deficit and in decision-making. (This kind of pension deal is consistent with the matching contribution approach contained in the current pension deal, but of course other changes to the current deal would be required if a shared risk/reward pension deal is desired.)

- a defined contribution deal where public servants have all of the investment reward and all of the risk and control decision-making. (We note that OFL and OPSEU representatives object to defined contribution plans.[19])

Integration of the PSSAF with the PSSF would be an essential part of either option.

[19] From a meeting with OFL and public sector union representatives, August 21, 1987. The OFL and OPSEU object to defined contribution plans on two grounds:

- An individual's eventual pension level in such a plan has an element of a lottery. Even if two employees build up the same capital to retirement, their annuities can be different depending on the interest rates at the time of their respective retirements.
- Because of this element of risk, a defined contribution plan is least attractive to those at the low end of the income hierarchy who are least able to accept risk.

Recommendation 8.10

The Government should initiate discussions with public servants and their representatives to see if they wish to retain their current deal or have a new pension deal – for example, a shared risk/reward deal or a defined contribution deal.

Conclusion

This chapter assessed the current pension deal with Ontario's public servants and noted three problems. It discussed public servants' and the OFL's comments on the current pension deal and the Task Force's response. It recommended changes that should be made to the current defined benefit related deal and discussed alternative new deals.

CHAPTER 9

SUPERANNUATION ADJUSTMENT FUND (SAF)

SYNOPSIS

The SAF is a modified pay-as-you-go plan designed to provide inflation indexing to teachers, public servants and Ryerson employees, based on the CPI up to a cap of 8 per cent. Depending on assumptions, the SAF currently has unfunded future obligations of about $8.5 billion. The SAF should invest in market investments. However, a clear and predictable funding policy is needed for the SAF as the basis for developing a market related investment policy. The SAF should be merged with the TSF, the PSSF and the Ryerson pension fund but, if it is not, it should be set up under a new Board at arms length from employers and plan members, with representation from each.

Introduction

This chapter reviews the inflation protection component of the current pension deals with teachers, public servants and Ryerson Polytechnical Institute employees, as set out in the Superannuation Adjustment Benefits Act (SABA).

The SAF is a modified pay-as-you-go fund. It is a component of the TSF, PSSF and Ryerson pension deals, designed to provide inflation protection to plan members, indexed to the CPI up to a cap of 8 per cent. The SAF is in reality three funds, one for teachers (the TSAF), one for public servants (the PSSAF) and one for Ryerson employees (the RSAF).[1]

Figure 9.1 provides an overview of the SAF.

[1] Employees of the caucuses of the three parties in the Legislature formerly had a separate SAF fund but as of 1986 are covered by the PSSF and PSSAF.

Overview of the SAF

December 31, 1986

Fund	Sector	Assets[1] ($ Million)	Rank by Assets	Employers	Active Plan Members	Benefi-ciaries[3]	1986 Cash Flow[4] ($ Million)	Surplus[5] (Deficit) ($ Million)
TSAF	Education	913	—	361[2]	140,639	13,067	158.0	N/A
PSSAF	Government	380	—	33	77,294	16,966	54.1	N/A
RSAF	Education	7	—	1	1,210	105	1.6	N/A
Total SAF		1,300	6	—	219,143	30,138	213.7	N/A

[1] Book value

[2] The province is the employer for pension purposes for teachers employed by 169 school boards and school districts.

[3] 1985 data

[4] Year ending March 31, 1987.

[5] The SAF is a modified pay-as-you-go plan and by design is only partially funded.

FIGURE 9.1

The SAF is Ontario's sixth largest public sector pension fund with assets of $1.3 billion as of December 31, 1986.[2] The Province is the plan sponsor and the principal employer/contributor to the fund. The SAF has over 219,000 plan members and over 30,000 plan beneficiaries. Its 1986 cash flow was about $214 million.

If the future liabilities of the TSAF and PSSAF were stated on a basis comparable to the TSF and PSSF, the unfunded future obligations for inflation protection for teachers and public servants would be about $8.5 billion as of December 31, 1985.[3]

This chapter is divided into three sections:

I. **The pension deal**

II. **Plan members' views**

III. **Changes needed to the pension deal**

[2] This number is the same as for the fiscal year-end as of March 31, 1986. Book value as of March 31, 1987 was $1.5 billion.

[3] This amount includes existing liabilities for present retirees and for present employees for the years worked to date, plus future liabilities for present employees for the expected number of years they will work from now until retirement. The interest rate assumption is based on the rate of return of existing investments (streamed basis). No change in contribution rates is assumed; this is not a realistic assumption as contribution rates clearly will need to be higher to meet the rising cost of benefits.

SECTION I

The Pension Deal

SABA provides inflation protection to members of pension plans designated by the regulations under the Act. At present, three plans are designated, covering teachers, public servants and employees of Ryerson Polytechnical Institute.

Before SABA was introduced in 1975, inflation adjustments to teachers' and public servants' pension benefits were made on an ad hoc basis from the Consolidated Revenue Fund. SABA provided that future inflation adjustments would be made annually, based on increases in the Consumer Price Index. Inflation adjustments for teachers and public servants who retired before 1975 are paid from the Consolidated Revenue Fund, while post-1975 inflation adjustments are paid from the SAF. The SAF is funded jointly by employees and by employers for pension purposes.

Figure 9.2 summarizes the roles and responsibilities of each party to the SABA pension deal.

SAF Roles and Responsibilities

Sponsor	Employers	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
Province	Province, School Boards, Ryerson, and others	Province, Ryerson, and others	Treasurer	None Designated	Legislature	Treasurer/ Review committees (limited role)

FIGURE 9.2

The Province of Ontario is the plan sponsor and the employer, or employer for pension purposes, of most plan members. The employer/contributors to the TSF, PSSF and the Ryerson Fund contribute 1 per cent of their employees' salaries to the fund. Employees also contribute 1 per cent of their salaries to the fund.

The Treasurer of Ontario is the custodian of the SAF. No trustee has been appointed. The Legislature has determined how the assets of the SAF are to be invested and so is the investment policy maker. The legislation provides that SAF monies are to be deposited in the accounts of the Province, and interest credited on such deposits at such rate and in such manner as the Lieutenant Governor in Council determines from time to time.

The Treasurer is advised on the terms of the non-market government debt, in which the SAF invests, by joint management/employee Review Committees set up under the Act for each of the TSAF, PSSAF and RSAF. Once the interest rate and terms of the deposits have been decided, there is no discretionary investment management because the assets of the SAF are non-marketable.

The Chairman of Management Board administers SABA.

Relationship of the Participants

Figure 9.3 illustrates the relationship among the various parties involved in the SAF.

SAF Structure and Decision-Making Relationships

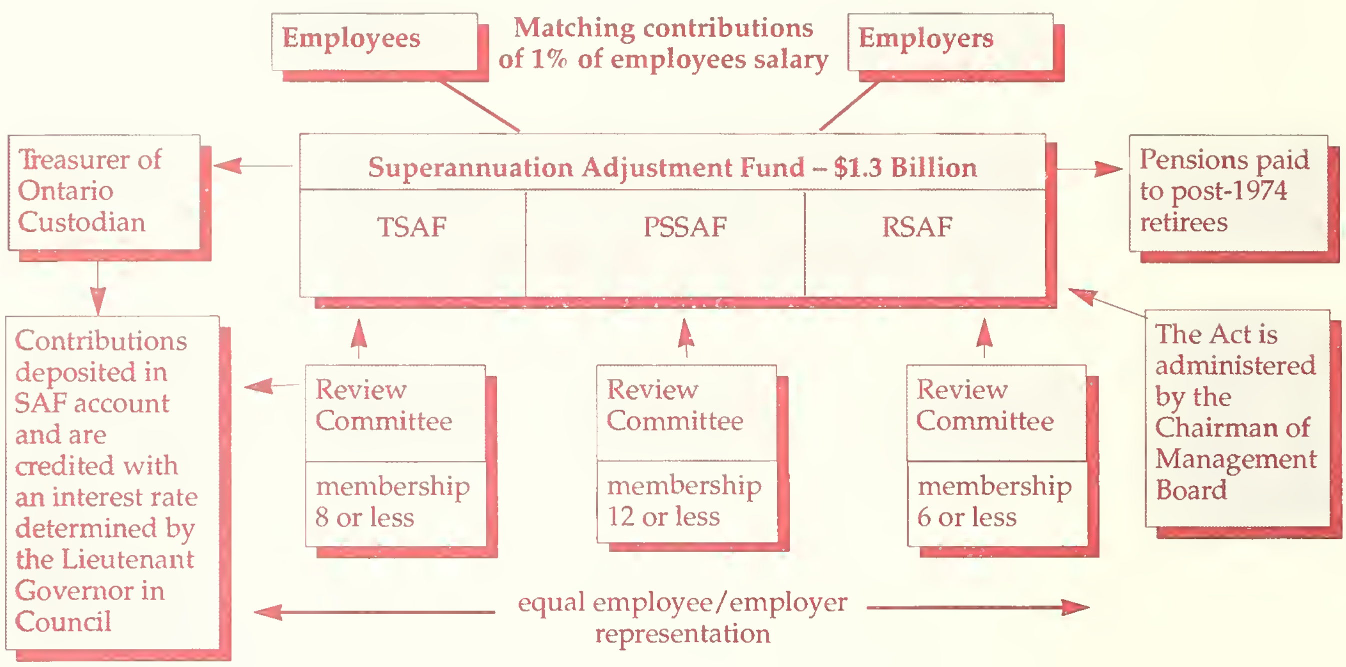


FIGURE 9.3

In addition to making recommendations on the term of investments, the three Review Committees also recommend future contribution rates and benefits.

Future Contribution Rates

The present contribution rates are sufficient to meet present annual benefit payments. However, benefit payments are expected to rise more quickly than total contributions (assuming the current contribution rates are maintained and assuming continuation of moderate inflation rates). As a result, the three SAF funds are projected to stop growing within the next few years and ultimately to go into deficit.

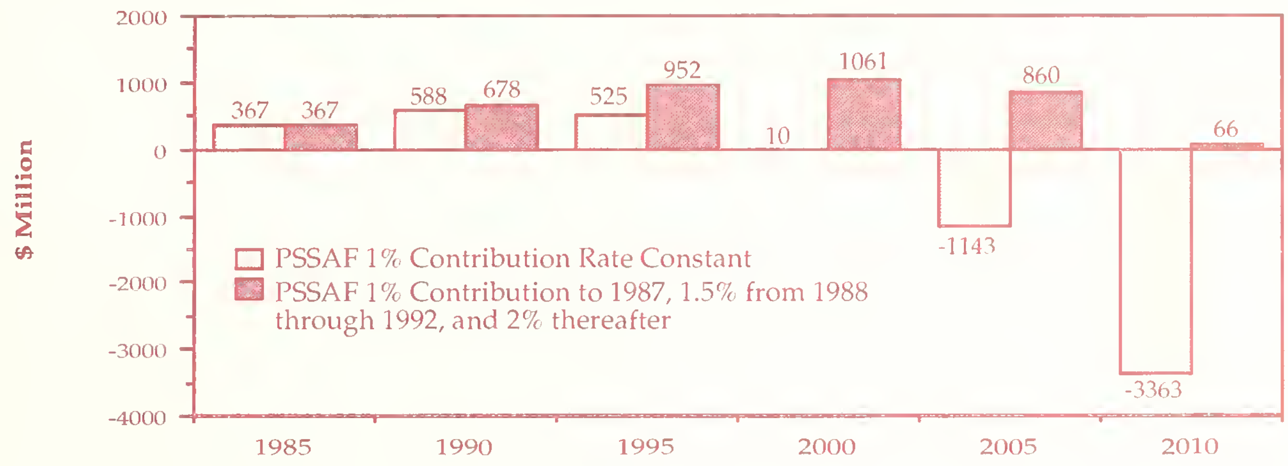
The timing of this transition from growth to decline differs among the TSAF, PSSAF and RSAF. The transition of course can be delayed if contribution rates are increased in the meantime.

Figure 9.4 illustrates the projected growth and decline of the PSSAF with two different assumptions about contribution rates. In both cases, the modified pay-as-you-go approach is maintained.[4]

[4] The figure is based on analysis and data provided to the PSSAF Review Committee in March, 1987.

Impact on the PSSAF of Different Contribution Rates, on a Cumulative Cash Flow Basis

1985 to 2010



Note: Liabilities based on a variable inflation rate assumption.
Source: Actuarial Services Branch, Human Resources Secretariat, Management Board of Cabinet

FIGURE 9.4

Figure 9.4 is based on a 25-year cumulative cash flow projection of the PSSAF with data as of December 31, 1985. With the present 1 per cent contribution rates for public servants and employers, the PSSAF will peak in 1992, go into a cash deficit in 2001 and have a cash deficit of almost $3.4 billion in 2010.[5]

If contribution rates for both employees and employers are increased to 1.5 per cent in 1988 and to 2 per cent in 1993, the PSSAF would not peak until 2000 and would still have a small cumulative cash flow in 2010. However, it is clear that further increases in contribution rates would be required above the 2 per cent level well before 2010 to avoid the PSSAF going into a cash deficit.

A similar pattern is expected to apply to the TSAF, although the TSAF cash deficit would be much larger. The timing of the shift to a cash deficit for the RSAF is expected to be delayed several years.

An Example of How Pension Indexation Works

TSF, PSSF and Ryerson pensions are indexed to the CPI up to a cap of 8 per cent. If the CPI is greater than 8 per cent, the difference is carried over until such time as the CPI is less than 8 per cent. If the CPI is negative, pensions are not reduced but the difference is carried forward and applied in a later year.

Figure 9.5 illustrates how the indexing provision of SABA would have worked for a hypothetical plan member retiring on June 30, 1978.

[5] These dates will be greatly affected by actual inflation and investment experience. However, the direction of change is clear.

An Example of How the SAF Pension Indexation Works*

Year	Applicable Consumer Price Index Change	Indexation Rate at January 1	Cumulative Escalation Carry-over	Increase in Indexation Amount	Annual Pension
1978	9.0%	—	—	—	10,000
1979	8.9%	4% **	—	$400	10,400
1980	9.8%	8%	0.9%	$832	11,232
1981	12.2%	8%	2.7%	$899	12,131
1982	11.5%	8%	6.9%	$970	13,101
1983	7.1%	8%	10.4%	$1,048	14,149
1984	4.6%	8%	9.5%	$1,132	15,281
1985	3.8%	8%	6.1%	$1,222	16,503
1986	4.1%	8%	1.9%	$1,320	17,824
1987	—	6%	—	$1,069	18,893

* Based on a contributor retiring on June 10, 1978 with a pension of $10,000 per annum.

** The normal escalation would be 8% but paid for only half the year (no escalation carry over in the first year).

Source: Human Resources Secretariat, Management Board of Cabinet

FIGURE 9.5

Formal Pension Deal vs. Current Practice

Figure 9.6 sets out the main components of the SABA pension deal. Unlike the basic pension deals for teachers and public servants, current practice is consistent with the formal pension deal.

Formal SAF Pension Deal

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Shared cost inflation protection plan	Inflation protection indexed to CPI up to a cap of 8%	Fixed matching contri-butions	Surplus: Not applicable – Pay/go plan Deficit: Not applicable – Pay/go plan	Non-market government debt (Trust Account)	Plan Admini-stration: Plan sponsor Investment Manage-ment: Treasurer/ Review committees (limited role)	Legislature and formal Review committees

FIGURE 9.6

The formal SABA pension deal can be summarized as follows:

- Pensions payable to plan members of the TSF, PSSF and Ryerson plans are automatically increased to match inflation as measured by the Consumer Price Index (CPI) up to a cap of 8 per cent a year, with a carryover.
- Pension increases for plan members who retired before 1975 (when the Act took effect) are paid directly by the employer/contributor. In 1985/86, the

Province paid $82.6 million in respect of teachers and $40.2 million in respect of public servants who retired before 1975.

- Benefits are financed on a modified pay-as-you-go basis. The employers (including the government) and the plan members make fixed matching contributions to the SAF. Contribution rate levels are considered each year by the Review Committees in light of the estimated annual cost of benefit payments. Obligations being incurred today are to be paid for in the future.

- Changing the pension deal requires a change to the Superannuation Adjustment Benefits Act.

- Investment policy is set by legislation. The SAF is required to invest in non-market government debt.

- The interest rate and term of the non market government debt is decided by the Treasurer, subject to the approval of the Lieutenant Governor in Council. The Review Committees recommend the term of investments.[6]
- Certain aspects of fund management are shared with employees through the Review Committees.

Problems with the Formal Pension Deal

There are four problems with the SAF pension deal:

- First, as illustrated in Figure 9.4, the present contribution rates will not be sufficient to maintain a fund as benefit costs increase. Under the current forecast the PSSAF will go into a cash deficit in 2001.

- Second, future liabilities relating to the SAF are not identified and funded on an ongoing basis as they are in the TSF, PSSF and the Ryerson fund. Currently, the SAF, if it were being funded like the TSF, PSSF and Ryerson fund, would have a deficit amounting to about $8.5 billion, depending on assumptions. As a result, future liabilities of the SAF with respect to current plan members are being passed on to future generations of plan members and taxpayers. Present employees and taxpayers generally are not aware of the underlying cost of the SAF benefits.

- Third, although the liabilities of the SAF are shared among plan members and many employers (in addition to the government), the investment policy of the SAF is set by legislation. The only input from plan members is through the Review Committees which advise on the terms of the non-market government debt.

- Fourth, the present investment policy for the SAF results in illiquid, long-term, fixed income assets which bear no relation to the inflation-sensitive liabilities of the SAF.

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[6] The Review Committees are provided with the interest rates which would apply for various terms and recommend a particular term. Their recommendations normally are implemented.

SECTION II

Plan Members' Views

This section reviews comments received from teachers and public servants, or their representatives, with respect to the current SAF pension deal and the Task Force's response. No brief was received from the Ministry of Education or from Management Board but we had discussions with staff of both.

Teachers' Views

Structure

Teacher representatives favour keeping the TSF separate from the TSAF, at least for the time being. They want issues relating to the TSAF to be put aside until the restructuring and diversification of the TSF are well advanced.

We do not endorse this position. In our view, the TSAF is directly related to the TSF. To separate discussions on these two funds would ignore that they are part of the same pension deal. Our views are discussed in more detail in Section III.

Investment Policy

Teachers want the TSAF invested in market investments. Since the ultimate liabilities of the TSAF are dependent on actual inflation experience, they expect it would have a different investment policy from the TSF, the liabilities of which are less influenced by inflation.

We agree that the TSAF should be invested in market investments, regardless of whether this is done as a separate fund or as part of a larger TSF.

Teachers also expect that a higher return on TSAF investments would help to reduce the need for future contribution rate increases for inflation protection.

Public Servants' Views

Structure

Representatives of public servants have suggested that the PSSAF be merged with the PSSF provided this is not done unilaterally and that OPSEU is a full participant in the process.[7]

There is no indication of public servants' views as to how the resulting liability would be shared between employers and employees and between current and future contributors. The OFL believes that a modified pay-as-you-go method of funding inflation indexation is the most practical and persuasive approach even though there is not a one-to-one relationship between who benefits and who pays. The OFL

[7] From March 19 and August 21, 1987 meetings with the OFL, including representatives of OPSEU.

argues that because of the difficulties in predicting inflation, actuaries would tend to use very cautious assumptions, resulting in considerable over-funding if the SAF was required to be fully funded.[8]

The Task Force's views are set out in Section III.

Investment Policy

Representatives of public servants want to invest at least some of the cash flow of the PSSAF in market investments, as part of the PSSF. Specifically, they propose to invest 10 per cent of total assets in market investments, and attribute the market rate to the remainder of the funds available for new investment in that year.[9]

We agree with the principle of market determined rates of return for both the PSSAF and the PSSF.

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the SAF pension deal to address the problems we have identified and to respond to some of the comments of plan members.

The problems which we identified earlier with respect to the SAF pension deal relate to:

- the policy for funding liabilities of the SAF
- the structure of the SAF relative to the three base funds
- the investment policy for the SAF.

Recommending an appropriate funding policy for the SAF is beyond our mandate. However, we cannot ignore the implications of different funding policies because of their implications for the structure of the SAF and its investment policy.

From an investment perspective, a very different investment policy would be appropriate for a fund which is steadily growing (such as the TSF and the PSSF) from one which is likely to decline and become negative. A fluctuating fund, such as would result from periodic increases in contribution rates for the SAF, would suggest yet another investment policy.

Without a clearly stated and reasonably predictable funding policy, development of an appropriate investment policy for the SAF is almost impossible.

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[8] Based on a meeting with the OFL on August 21, 1987.

[9] OFL Brief, page 23. Subsequently on August 24, 1987, the OFL advised that OPSEU were not opposed to 100 per cent of the PSSF assets being invested in the capital markets.

Nine Options

We have looked at nine funding, structure and investment policy options for the SAF as illustrated in Figure 9.7.

Nine Funding, Structure and Investment Policy Options for the SAF

Option 1	Option 2	Option 3
• current contribution rate • separate SAF • non-market investments	• increasing contribution rates • separate SAF • non-market investments	• fully funded • separate SAF • non-market investments
Option 4	**Option 5**	**Option 6**
• current contribution rates • separate SAF • market investments	• increasing contribution rates • separate SAF • market investments	• fully funded • separate SAF • market investments
Option 7	**Option 8**	**Option 9**
• current contribution rates • merge SAF funds with base funds • market investments	• increasing contribution rates • merge SAF funds with base funds • market investments	• fully funded • merge SAF funds with base funds • market investments

FIGURE 9.7

These nine options are as follows:

1. The status quo, i.e. continue to invest in non-market government debt with no change to the current pay-as-you-go funding policy and maintaining the SAF separate from the base TSF, PSSF and Ryerson fund.

2. A modified status quo, i.e. continue to invest SAF assets in non-market government debt, separate from the base TSF, PSSF and Ryerson fund, but with increasing contribution rates such that the SAF does not get any smaller but is still not on a fully funded basis.

3. Continue to invest SAF assets in non-market government debt, separate from the base TSF, PSSF and Ryerson fund but with a policy to fully fund inflation indexation.

4. To invest SAF assets in market investments separate from the base TSF, PSSF and Ryerson fund with no change in the current pay-as-you-go contribution rates.

5. To invest SAF assets in market investments, separate from the base TSF, PSSF and Ryerson fund, but with increasing contribution rates such that the SAF does not get any smaller but is still not on a fully funded basis.

6. To invest SAF assets in market investments separate from the base TSF, PSSF and Ryerson funds, but based on a policy to fully fund inflation indexation.

7. To merge the three SAF funds with the respective base TSF, PSSF and Ryerson fund with no change in the current pay-as-you-go contribution rates.

8. To merge the three SAF funds with the respective base TSF, PSSF and Ryerson fund but with increasing contribution rates such that the SAF does not get any smaller but is still not on a fully funded basis.

9. To merge the three SAF funds with the base TSF, PSSF and Ryerson fund but based on a policy to fully fund inflation indexation.

Review of the Options

For reasons set out in Chapter 5, we rejected options 1, 2 and 3 because they involve investing in non-market government debt.

Options 4 and 7 were rejected because the current pay-as-you-go contribution rate result in the SAF shortly going into a cash deficit. Clearly, as Figure 9.4 shows, these options are not tenable under any circumstances.

Options 5 and 6 were rejected because, in the Task Force's view, if there are continuing assets in the SAF, it is preferable that they be merged with the base funds and their investment management be the responsibility of the boards of governors of the base funds.

Only options 8 and 9 are thus left for consideration.

While our strong preference is for inflation indexation to be fully funded, it is not our role to recommend an appropriate funding policy for the SAF.

Suffice it to say, we do not believe it is fair for current plan members and taxpayers to push the cost of inflation indexation off onto future generations of plan members and taxpayers. As Figure 16.2 (in Chapter 16) graphically demonstrates, future plan members and taxpayers will be paying an increasing proportion of salary for various kinds of post-retirement income schemes.

Either option 8 or 9 would result in enough assets in the SAF to make investment in wealth-producing assets a worthwhile proposition.

Recommendation 9.1

The Management Board of Cabinet should initiate discussions with the three SAF Review Committees with the object of developing a funding policy for the TSAF, the PSSAF and the RSAF which fairly apportions the cost of inflation indexation between current and future plan members and taxpayers.

Pension Fund Structure

As presently structured, the SAF is, for all intents and purposes, an integral part of the public accounts of Ontario. There is no trustee and the fund is not established at arms length from the employer/plan sponsor. We believe that the appropriate SAF assets should be merged with the TSF and PSSF once these funds are established as arms-length investment agencies and a more realistic SAF funding policy is in place.

Recommendation 9.2

The appropriate assets of the SAF should be merged with the TSF and PSSF once these funds have been established as arms-length investment agencies, as per Recommendations 7.1 and 8.1, and a more realistic inflation indexation funding policy is in place. Similarly, the RSAF assets should be merged with the Ryerson fund once a more realistic inflation indexation funding policy is in place.

Investment Policy: Market Investments

The current investment policy requires SAF contributions and interest (net of expenses) to be deposited into the SAF (i.e. invested in varying term, non-market government debt). That policy implicitly creates a long term, fixed income portfolio, with a lower rate of return than a diversified portfolio would provide.

As noted in Chapter 5, if the funds currently invested in non-market government debt had been invested in a diversified portfolio of market investments, the rate of return of SAF investments might have been 2 per cent higher over the past decade.

This should not be translated into an expectation that a shift to diversified market investments would earn 2 per cent more in the future. However, the Task Force is of the view that a diversified portfolio would likely achieve a higher rate of return without significantly increasing the level of risk.[10]

This higher rate of return would reduce future fund liabilities.

See Chapter 5, Section IV for an explanation of the effect on the Province's finances of investing SAF cash flow in the capital market. In brief, the Province's annual net cash requirements would increase by about $200 million. Such a change in financial presentation would not change the Province's underlying financial position as measured by the budgetary deficit and the operating deficit.

Since it will take time to make the legislative changes and hire external investment managers, it is unlikely that such market investment could begin in less than 18 months after a decision to proceed is made.

Recommendation 9.3

Subject to Recommendation 9.1, the net cash flow of the three SAF funds should be invested in market investments as part of the TSF, PSSF and Ryerson fund, beginning in 1989: 20 per cent in the first year, 50 per cent in the second year and 100 per cent in the third and subsequent years.

Recommendation 9.4

Subject to Recommendation 9.1, non-market government debt held by the SAF should be reinvested in market investments as it matures, through the TSF, PSSF and Ryerson fund.

Investment Policy: Level of Risk

The current legislative requirement is that SAF assets be invested in non-market government debt. In effect, this is the SAF's investment policy.

It is a rigid investment policy with no particular relationship to the liabilities of the plan and with no explicit decision on the appropriate level of investment risk.

Although investing in government debt is very secure (i.e. there is little or no risk of default), such investments are not risk-free to a pension fund in a broader sense. For example, the return on long-term fixed income debt is not responsive to changes in

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[10] For a discussion of risk, see Research Report #4, *Market vs Non-Market Investments,* pages 15-18.

inflation and therefore will not track liabilities if inflation rates change. Moreover, the assets of the SAF are non-marketable and so cannot be traded for other types of assets which might be more consistent with the nature of the liabilities of the SAF.

We believe that this investment policy is inappropriate and should be changed to one which maximizes the return to the SAF, at an appropriate level of risk in light of the liabilities. New investment policies for the base funds when merged with their respective SAF funds would need to be very responsive to inflation rates.[11]

Recommendation 9.5

Concurrent with a shift to market investments and with a merger of the three SAF funds with the TSF, PSSF and Ryerson fund respectively, the investment policies of the merged funds should maximize the return to the base funds at appropriate levels of risk.

Conclusion

This chapter described the SAF pension deal and noted four problems. It identified the views of teachers and public servants, and their representatives. It reviewed options for funding, structure and investment policy for the SAF and made recommendations for change.

[11] We note in this respect the arguments advanced in favour of governments issuing indexed debt as a source of indexed assets for pension funds which have built-in inflation indexing. We have no comment on such schemes other than to question whether transferring inflation risk from the plan members and employers to taxpayers is fair.

CHAPTER 10

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT SYSTEM (OMERS)

SYNOPSIS

OMERS has earned a good reputation since it began investing in market investments in 1976. However, current practice in the pension deal is not consistent with the formal pension deal. There are two options to bring them into line: change current practice or change the formal pension deal. OMERS administers the CAATS and RYERSON pension plans and funds but its service has been substandard. CAATS should not establish its own fund until the roles and responsibilities of the various parties to the CAATS pension deal have been clarified.

Introduction

This chapter examines the current pension deal for employees covered by the Ontario Municipal Employees Retirement System (OMERS). It also reviews the comments expressed by representatives of plan members and by the OMERS Board, and the Task Force's response.

The Chapter then examines the relationship between OMERS and the pension plans and funds of the Colleges of Applied Arts and Technology (CAATS) and Ryerson Polytechnical Institute (RYERSON), for which OMERS provides plan administration and investment management services.

OMERS is a multi-employer pension plan, with 1,069 employers as of December 31, 1986. OMERS was established to provide Ontario's local governments and boards with a defined benefit retirement system at uniform, stable and reasonable rates of contributions, regardless of the age or the sex of their employees and regardless of the size or location of the local government, board or institution.

Figure 10.1 provides an overview of the OMERS, CAATS and RYERSON funds.

Overview of OMERS as at December 31, 1986

Fund	Sector	Assets[1] ($ Billion)	Rank by Assets	Employers	Active Plan Members	Beneficiaries	1986 Cash Flow[3] ($ Million)	Surplus[3,4] (Deficit) ($ Million)
OMERS[2]	Municipal	7.32	2	1069	140,120	33,340	1,134	504
CAATS	Education	0.86	7	22	15,655	1,607	133	59
RYERSON	Education	0.084	28	1	1,210	144	13	6
Total	—	**8.264**	**2**	**1092**	**156,985**	**35,091**	**1,280**	**569**

1. Market investments at market value. Non-market government debt at book value.
2. Not including CAATS and RYERSON.
3. Annual cash flow and surplus are pro rated for OMERS, CAATS and RYERSON on the basis of their respective asset sizes in proportion to total assets.
4. As at December 31, 1986.

FIGURE 10.1

With or without CAATS and RYERSON assets, OMERS is Ontario's second largest public sector pension fund. Excluding CAATS and RYERSON, OMERS has assets of approximately $7.3 billion, over 140,000 plan members and over 33,000 beneficiaries. Its cash flow in 1986 was over $1.1 billion. There was an estimated surplus of $504 million as of December 31, 1986. The employers and employees who participate in OMERS and the major unions which represent the employees are shown in Figure 10.2.

Employers Participating in the OMERS Pension Deal and the Major Unions Representing Most of Those Employees

Employers	Number 1985	Number 1986	Employees 1985	Employees 1986	Major Unions
					1. Canadian Union of Public Employees (CUPE)
Municipalities	504	507	69,469	71,703	2. Ontario Public Service Employees Union (OPSEU)
Local Boards	426	430	31,061	32,259	3. International Brotherhood of Electrical Workers (IBEW)
School Boards	133	132	34,568	36,158	4. Service Employees International (SEIU)
Total	**1063**	**1069**	**135,098**	**140,120**	5. Ontario Professional Fire Fighters Association
					6. Police Association of Ontario

FIGURE 10.2

OMERS represents a group of large and small municipal employers. In 1986, over 550 of the employers had fewer than 25 plan members, with an average of nine plan members. At the other extreme, 59 per cent of plan members were employed by 63 employers with an average of 1,313 plan members.

The relationship of the 1,069 employers to the Ontario Government varies significantly. Some are quite independent in a financial and policy sense (e.g.

municipal electric utilities), while others are highly dependent (e.g. certain agencies are funded entirely by the Province).

The chapter is divided into five sections:

I. **The pension deal**

II. **Views of plan members and the OMERS Board**

III. **Changes needed to the pension deal**

IV. CAATS

V. RYERSON

SECTION I

The Pension Deal

Roles of Participants

The OMERS pension deal is set out in the Ontario Municipal Employees Retirement System Act.

Figure 10.3 summarizes the roles and responsibilities of the various parties to the OMERS pension deal.

OMERS Roles and Responsibilities

Sponsor	Employer	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
Province	Municipal-ities and Boards	Municipal-ities and Boards	OMERS Board	None Designated	OMERS Board	OMERS Staff

FIGURE 10.3

There is a variety of views as to who is the sponsor of the OMERS pension plan. We believe it is the Province of Ontario.

The OMERS Act specifies that any local government, board or institution which chooses to have a pension plan after 1965 must participate in OMERS. Pension plans in existence before 1965 may continue but may not take in new members. All employees hired by those employers since 1965 are members of OMERS.

The OMERS Board is the custodian and investment policy maker of OMERS. No trustee has been appointed, although implicitly the trustee is the OMERS Board. The OMERS staff is the principal investment manager of the OMERS fund.

As of the end of 1986, 1,069 individual employers were participating in OMERS.

The OMERS Act confers control of the OMERS plan and fund on the OMERS Board. Changes to benefits or employee contribution rates require approval by the

Lieutenant Governor in Council, either at the Government's initiative or that of the OMERS Board.

The OMERS Act provides that the OMERS Board is to be appointed by the Lieutenant Governor in Council and is to be composed of eight active plan members (of whom at least three are to be officers of participating employers), two members of the council or board of a participating employer and one government official.

Relationship of the Participants

Figure 10.4 below illustrates the relationship among the various parties involved in OMERS.

OMERS Structure and Decision-Making Relationships

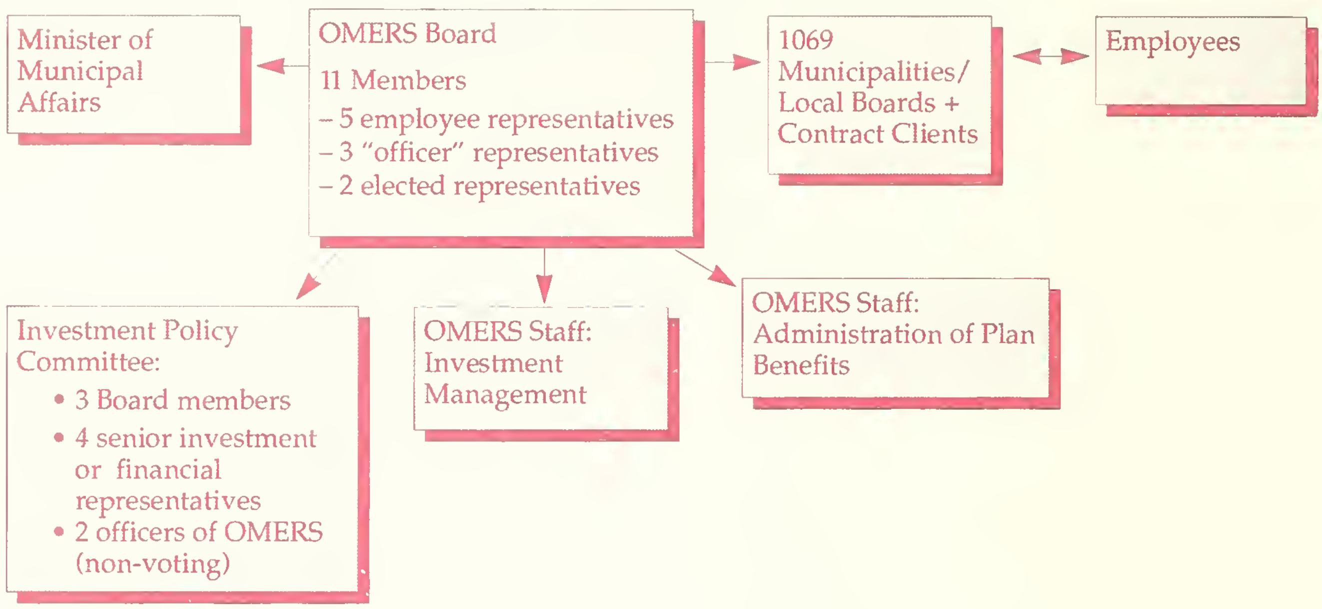


FIGURE 10.4

The Minister of Municipal Affairs is responsible for the OMERS Act. The Minister is the first stage in the decision-making process within the Government for approval by the Lieutenant Governor in Council of changes in OMERS benefits or employee contribution rates.

The OMERS Board has been the investment policy maker since 1975 when OMERS began investing in market investments. Before that, all investments were in non-market Ontario Government debentures.

Under the OMERS Act, the OMERS Board may appoint an investment policy committee and may delegate to the committee the power to invest the OMERS fund. In turn, the investment policy committee, with the approval of the OMERS Board, may delegate duties to OMERS staff.

Investment Policy Committee

The OMERS Board appoints two of its members and four outside members with investment or financial management experience, plus the OMERS Executive

Director, Director of Investments and Chairman of the Board to the Investment Policy Committee. The Committee's terms of reference are as follows:

- to recommend asset mix policy
- to devise a plan to invest available funds each quarter, including an explanation of variances for the previous quarter
- to develop a statement of investment powers to be delegated to OMERS staff
- to report to the Board on investments recommended by OMERS staff that require Board approval
- to report on all outside investment managers, excluding mutual funds, and the initial amount of funds allocated to such managers
- to examine all investments of a type or form not previously included in the portfolio
- to advise on the hiring of consultants or advisors where a budgetary allocation has not been made previously by the Board
- to report on the formation of any wholly-owned subsidiary in relation to a specific investment.

Investment Management

The OMERS Director of Investments is responsible for the day to day operation of the OMERS fund and for monitoring market conditions. The majority of investment transactions are conducted in-house by OMERS' staff. Approximately 10 per cent of investments are managed by outside managers, primarily in non-North American equities, term lending, real estate, private placements, venture capital and oil and gas properties.

A committee of internal OMERS investment managers, responsible for debt, equity, properties, property development and policy and research, meets weekly and reports its findings on capital market developments to the Investment Policy Committee.

Investment Policy

OMERS investment policy is to obtain the highest rate of return, given an appropriate degree of diversification to control volatility, so that uniform and portable pension benefits can be ensured.

Apart from the $1.3 billion in non-market government debentures it still holds, OMERS invests in a widely diversified portfolio of market investments including equities, bonds, short-term money market securities, mortgages, real estate, term loans, and venture capital and oil and gas properties.

Figure 10.5 summarizes the OMERS investment portfolio in 1986.

Percentage of Assets Invested in 1986

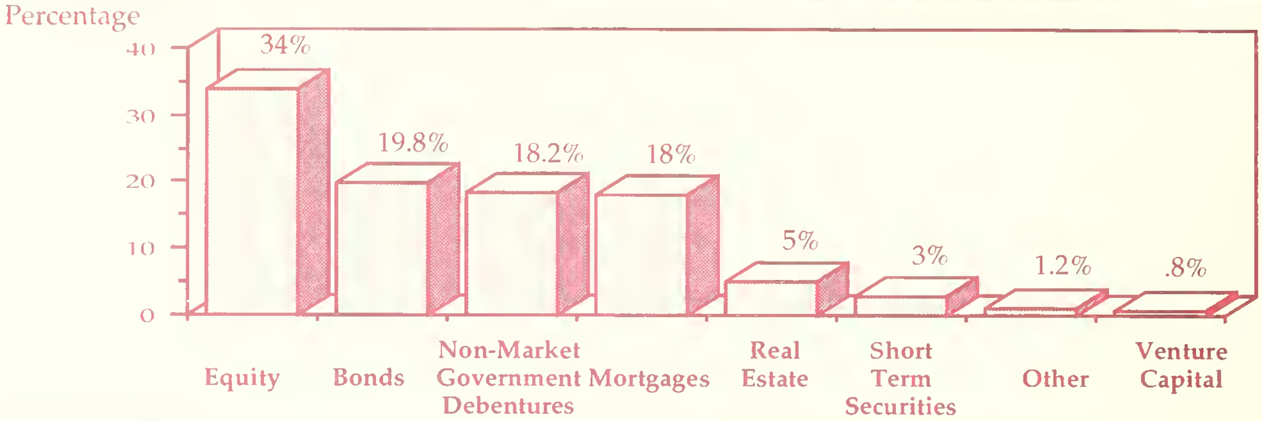


FIGURE 10.5

Figure 10.6 lists the non-market debentures held by OMERS, with the principal outstanding and maturity dates. On maturity, the proceeds of the debentures are expected to be invested by OMERS in market investments. In the meantime, the Treasurer of Ontario is the custodian of the debentures.

OMERS Inventory of Non-Market Province of Ontario Debentures

Year of Issue	Term Years	Maturity Date	Coupon Rate	Principal Outstanding
1963	30	31 Dec 1993	5.49%	$ 4,400,000
1964	30	31 Dec 1994	5.56%	10,700,000
1965	30	31 Dec 1995	5.54%	14,100,000
1966	30	31 Dec 1996	6.00%	20,100,000
1967	30	31 Dec 1997	6.30%	24,900,000
1968	30	31 Dec 1998	7.21%	33,100,000
1969	30	31 Dec 1999	8.19%	46,700,000
1970	30	31 Dec 2000	9.10%	57,600,000
1971	30	31 Dec 2001	7.85%	75,000,000
1972	30	31 Dec 2002	8.02%	91,300,000
1973	20	31 Dec 1993	8.15%	125,100,000
1974	20	31 Dec 1994	9.81%	138,125,000
1975	20	31 Dec 1995	10.05%	168,150,000
1976	26	31 Dec 2002	10.28%	174,500,000
1977	26	31 Dec 2003	9.45%	187,950,000
1978	26	31 Dec 2004	9.77%	121,300,000
Total Non-Market Province of Ontario Debentures			9.07%	$1,293,025,000

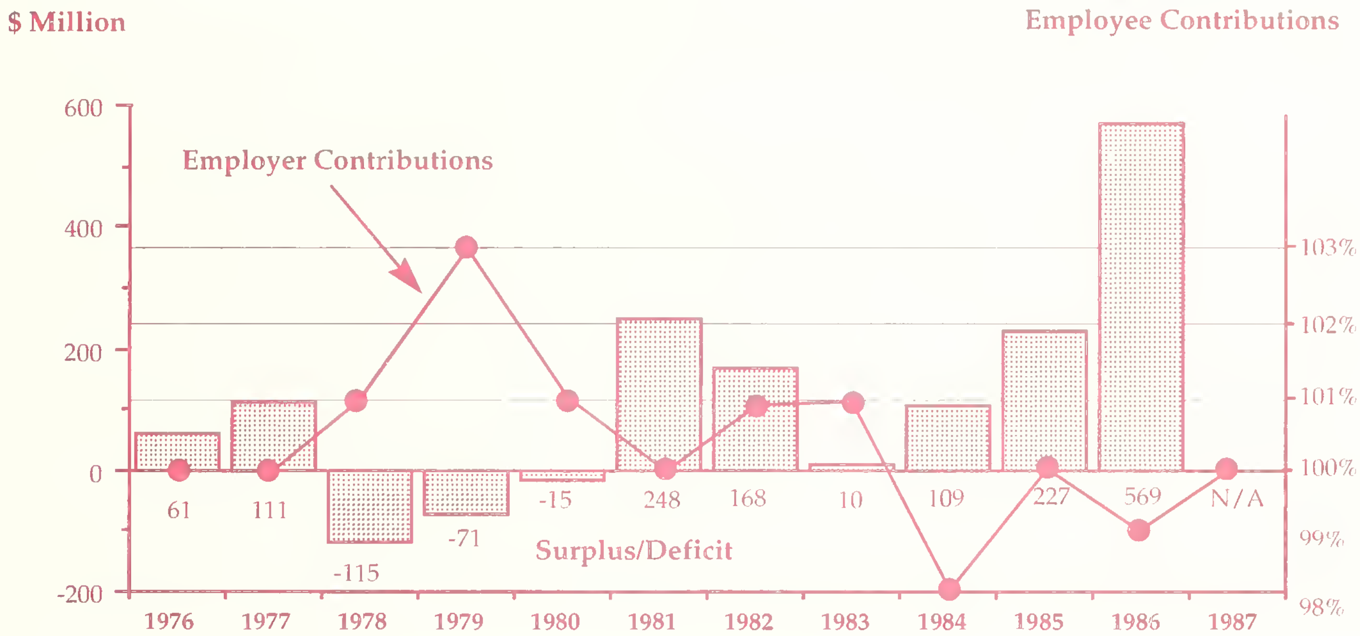
FIGURE 10.6

Record of Surpluses and Deficits and Employer Contribution Rates

Figure 10.7 illustrates the record of surpluses and deficits in the OMERS Fund since 1976, and the employer contributions as a percentage of employee contributions in each year over the period.[1]

Comparison of the OMERS Surplus (Deficit) and the Employer Contributions as a Percentage of Employee Contributions

1976-1986



Source: Public Sector Pensions Advisory Board Staff and OMERS

FIGURE 10.7

The OMERS Fund had deficits in 1978, 1979 and 1980 but had a surplus in all other years since 1976. The most recent actuarial valuation as of December 31, 1986 showed a surplus of $569 million.

The basic OMERS employer contribution rate has been set by the Board to match employee contributions in all years.

In any one year, however, actual employer and employee contributions may not match precisely. For example, the increase to 103 per cent in employer contributions relative to employee contributions in 1979 was due to a combination of circumstances requiring extra employer contributions but was not related to the deficit at the time. The main reason why employer contributions dipped below 100 per cent of employee contributions in 1984 and 1986 was because of employees purchasing additional credits for leaves of absence or waiting periods before deadlines imposed by OMERS.

The deficits in 1978, 1979 and 1980 arose in connection with the introduction of a highest average earnings benefit formula in 1978. Contribution rates for both

[1] Employer and employee contributions are those related to the basic OMERS plan and do not include contributions in respect of certain additional benefits negotiated by employee groups with their employer.

employers and employees were increased by 1 1/2 per cent, to 7 per cent, at that time. This joint increase was judged to be more than sufficient to fund the improved benefits. As a result, further employer contributions on account of the deficit were not required, and the Fund gradually moved back to a surplus.

The shift to market investments in the late 1970's has improved the rate of return and has contributed to the subsequent surpluses.

Growth of OMERS

The growth of OMERS is illustrated in Figure 10.8.

Growth of OMERS: 1965-1986

Year	Assets* ($ Billion)	Active Plan Members	Annual Contributions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1965	0.03	23,942	14.0	359	0.076
1975	0.839	97,275	129.2	3,463	8.98
1980	2.491	119,731	283.4	19,270	35.48
1986	8.264	140,120	462.0	33,340	135.5

* Market value. The non-market government debt held by OMERS is at book value.

FIGURE 10.8

Since 1965, the market value of OMERS assets has increased by over 277 times, the number of active plan members has increased by over six times, the number of pensioners has increased by over 93 times and the annual pension benefits paid have increased by 1,783 times.

Formal Pension Deal vs Current Practice

Figure 10.9 compares the formal pension deal for OMERS with current practice and identifies areas of difference (represented by shaded areas).

The **formal pension deal** can be summarized as follows:

- The pension deal is a defined benefit related deal.
- The pension benefit is determined by a formula based on a combination of years of service and the average salary earned in the best five years of service.
- The employees make fixed contributions to the fund of 7 per cent of salary above the CPP maximum earnings level.[2] The employers make variable contributions based on what is needed to keep the fund actuarially sound.
- The employers are legally responsible for any deficit.
- Who owns a surplus is not stated.

[2] Police and fire fighters make contributions of 8 per cent of salary.

OMERS ~ Formal Pension Deal

Kind of Deal	Benefit Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit *	2% per year of service based on best 5 years	Employee: fixed Employer: variable	Surplus: not stated Deficit: employer	Market investments (some residual non-market government debt)	Plan Administration: Shared but plan member majority Investment Management: Shared but plan member majority	Legislation & Regulations & OMERS Board initiative

* See "Problems with the Pension Deal" below.

OMERS ~ Current Practice

Kind of Deal	Benefit Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit & Plan member surplus*	2% per year of service based on best 5 years & ad hoc inflation	Matching	Surplus: plan members Deficit: employer **	Market Investments (some residual non-market government debt)	Plan Administration: Shared but plan member majority Investment Management: Shared but plan member majority	Legislation & Regulations & OMERS Board initiative

* See "Problems with the Pension Deal" below.
** As noted in the text, the deficits in 1978-80 were paid for jointly by employers and employees through a higher contribution rate. There have been no subsequent deficits.

FIGURE 10.9

- The Province is the plan sponsor. The employer/contributors are local governments, boards and institutions.
- The OMERS Board is appointed by the Lieutenant Governor in Council, and must be composed of:
  - eight active plan members, at least three of whom must be management-level personnel of a participating employer
  - two members of the council or board of a participating employer
  - one official of the Government.
- Investment policy, investment management and plan administration are the responsibility of the OMERS Board.
- The pension deal can be changed in two ways. Fundamental change requires legislative approval. Changes to benefits and the employee contribution rate are made on the recommendation of the OMERS Board, subject to the approval of the Lieutenant Governor in Council.
- The OMERS pension deal is not negotiable. However, employee groups can negotiate with their employer certain additional benefits (including past service credits, disability pensions and, in some cases, early retirement) at a higher cost. As well, there is substantial consultation among OMERS, employers and plan members (and their representatives) on major benefit changes.

Current practice differs from the formal pension deal in four ways:

- First, to date, all of the surplus which has been distributed has been used for the benefit of plan members, in the form of benefit improvements and ad hoc inflation adjustments.[3]
- Second, while the OMERS Act provides that employers will pay whatever is necessary to keep the Fund actuarially sound, the deficits in 1978, 1979 and 1980 were offset by higher contribution rates of both employers and employees. In that the Fund has been in surplus since 1981, there has not been a more recent test of this precedent.
- Third, while the OMERS Act fixes employee contributions and provides that employers' (i.e. taxpayers') contributions are variable, the OMERS Board has set employer contribution rates to match employee contribution rates.
- Fourth, the OMERS Board has provided ad hoc inflation adjustments, with the approval of the Lieutenant Governor in Council.

Problems with the Formal Pension Deal

In our view, there are three problems with the formal pension deal:

- First, there is a lack of clarity with respect to who owns a surplus. According to the OMERS Act, the employers bear the burden of any deficit, but the deal is silent on who benefits from any surplus. To date, to the extent that the OMERS Board has distributed the surplus, it has been used only for the benefit of plan members in the form of benefit improvements and ad hoc inflation adjustments, rather than benefiting taxpayers through lower contribution rates.[4]
- The matching employer/employee contribution practice is more consistent with a combined defined benefit/asset related deal than with the existing defined benefit deal.
- Although the employers are responsible for both an actuarial deficit and an investment risk deficit, employers do not control the pension fund. Of the eleven Board members, five represent management of participating employers and five represent non-management plan members. At least eight of the Board members are also plan members. Moreover, since members of councils or boards of participating employers potentially can be

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[3] Not all of the surplus has been used. The unused surplus provides an asset cushion against sudden changes in value during capital market cycles. This serves the purpose of reducing the need to vary the employer's contribution rate in order to match the liabilities of the pension plan. We are advised by OMERS staff that this is an important consideration in a multi-employer plan such as OMERS.

OMERS advises that a portion of the distributed surplus has been used to bring OMERS' pension benefits into line with other public sector employees.

OMERS also advises that it is not the policy of the Board to use the OMERS surplus only for the benefit of plan members, even though that has been the practice to date.

[4] Any benefit improvements using the surplus have been approved by the Lieutenant Governor in Council. While the Province has on occasion rejected proposals by OMERS for benefit improvements, nonetheless it has concurred (to date, at least) with a practice that any surplus which is distributed is used solely for the benefit of plan members.

members of OMERS, all of the OMERS Board members could be plan members except for the one provincial representative.

This representation, in our view, leaves employers (i.e. the taxpayers) vulnerable to inappropriate decisions on contribution policy, investment policy and distribution of surpluses. It is difficult to see how the taxpayer's interest can be represented effectively if the OMERS Board is composed almost entirely of plan members.

In our view, the net effect of the three problems we have identified is that the taxpayers' interest is not given sufficient weight.

The Task Force is aware that some of those involved with OMERS feel that the three problems we have identified can also be seen as some of the more attractive features of OMERS. Without challenging this view, we observe that the current practice implies a different kind of pension deal, one that has full sharing of risk and reward between employers and employees.

Perhaps the OMERS pension deal has evolved in the way it has in order to compensate for the fact that it is offering a standard pension deal to a wide variety of employee groups in a structure that does not permit total compensation bargaining.

SECTION II

Views of Plan Members and OMERS Board

This section reviews comments received from the OFL, from plan members and from the OMERS Board, along with the Task Force's response.

The OFL brief was made in conjunction with four affiliates which represent a large number of the unionized employees in the municipal sector. Briefs were also received from associations representing policemen, firemen, school board business officials and one CUPE local.

The comments received from the OFL for the most part were not directed specifically to the OMERS Fund. As a result, we have exercised judgement in relating their comments to the OMERS Fund.

The comments fall into the following categories:

- employer guarantee of defined benefit
- employer contribution rates
- inflation indexation
- ownership of a surplus (deficit)
- pension fund structure and control
- centralization of pension funds
- investment policy
- changing the pension deal

Employer Guarantee of Defined Benefit

The OFL favours a defined benefit plan (as opposed to a defined contribution plan) because it believes the employer has a higher tolerance for risk than do plan members. In the OFL's view, the employer should guarantee the pension promise and pay for any deficit in the pension fund but not have access to any pension fund surplus, no matter how derived.

The OFL states that a pension deal of this kind is "just good public policy." Indeed, even if collective bargaining for pensions took place in the municipal sector and unions were not able to negotiate this kind of deal, the OFL says that legislative remedies would be the logical next step.[5]

We do not endorse the OFL's position. Among other matters, the OFL's position ignores two essential points:

- whether an individual employee does or does not have a higher tolerance for risk than the individual taxpayer has not been demonstrated.
- even if it is true that taxpayers, either individually or collectively, have a higher tolerance for risk, it does not follow that taxpayers should be asked to bear a disproportionate amount of risk.

Public policy may ultimately support the OFL's point of view. Before it does, we would point out the very high cost to the taxpayers if such a policy is applied to public sector pension plans.

The OMERS brief does not address this issue, noting only that OMERS is a defined benefit plan. However, the actions taken to date by the OMERS Board have led to a result similar to that advocated by the OFL.

Employer Contribution Rates

Employer contribution rates in OMERS consistently have been set by the OMERS Board to match employee contribution rates.

The OFL states that "public sector unions believe that employer contribution rates should never be allowed to fall below the prior year's rate of contribution (and) in no event should employer contributions ever be allowed to fall below employee contributions when the plan is contributory."[6]

By its action in setting the employers' contribution rates to match the employees' contribution rates, the OMERS Board appears implicitly to concur with the OFL.

We do not endorse this position. A key component of the formal OMERS pension deal is variable employer contribution rates (Section 11 of the OMERS Act).

As noted earlier, when an improved benefit formula was introduced for OMERS in 1978, the higher cost of the new benefit was shared equally by employers and employees, through higher contributions. Apparently, this cost sharing was a condition of Provincial approval of the benefit change. However, the sharing of the cost of the 1978 benefit improvement, in our view, should not result in an ongoing

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[5] Based on a meeting with the OFL, August 21, 1987.

[6] OFL Brief, page 21.

matching contribution rate policy. As plan experience varies, so could employer contribution rates.

It should be noted that where an employer has the right under a pension deal to vary his contribution rate, the Pension Benefits Act, 1987 may impose constraints on that right. Section 40 of that Act in effect requires that employer contributions plus any investment earnings thereon must add up to at least 50 per cent of the value of a plan member's pension in respect of years after 1986. However, this is not a requirement that the employer's contributions must at all times match or exceed the employees' contribution. The calculation required by Section 40 is based on the entire period of a plan member's employment.

Inflation Indexation

The OFL argues that, in conditions of inflation, the pension promise is essentially broken if pensions are not indexed. The OFL also states that "surpluses of most pension plans arise precisely because the real value of benefits (to retirees) are eroded".[7]

The OMERS Board points to a record of ad hoc inflation adjustments. These have been provided over the years without any increase in member and employer contribution levels.[8]

We note that mandatory inflation indexing is to be implemented under the Pension Benefits Act, 1987. The Task Force on Inflation Protection for Employment Pension Plans is addressing the means by which it can be implemented.

Ownership of a Surplus (Deficit)

Representatives of plan members claim ownership of any surplus in the OMERS fund. The general view (including the OFL's) is that a surplus in a pension fund should be used to improve the benefits of active plan members, to provide inflation protection for pensioners and their beneficiaries and to extend coverage to other workers.

We do not endorse this position.

In Chapter 3, we advanced the proposition that a surplus can have two parts:

- an actuarial surplus, and
- an investment risk surplus.[9]

This distinction is useful in thinking through which party or parties may be entitled to which parts of a surplus, although the assumptions underlying an existing actuarial surplus may not have been structured so as to assist in allocating it.

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[7] OFL Brief, page 21.

[8] Ontario Municipal Employees Retirement System (OMERS) Brief to the Task Force on the Investment of Public Sector Pension Funds, March 5, 1987, page 1.

[9] An investment risk surplus (or deficit) results from adopting an investment policy with a level of risk above that related to an investment policy that is essentially risk free.

An actuarial surplus is the remainder of any surplus and results from actual experience being better than the actuary assumed.

There is a plausible argument, in the context of a contributory defined benefit pension deal with matching contributions (such as is the case with current OMERS practice), that plan members may be entitled to a share of an actuarial surplus. This argument is based on the view that, if employee contribution rates are determined, implicitly or explicitly, on the basis of conservative (as opposed to best estimate) actuarial assumptions, leading to an actuarial surplus, employees are entitled to that part of the actuarial surplus that results from their over-contributions.

Further, the taxpayer also is entitled to that part of the actuarial surplus resulting from employer over-contributions. And the taxpayer alone should be entitled to any investment risk surplus if it is clear that he bears the burden of any deficit.

The current practice in OMERS of setting employer contribution rates to match employee contribution rates, together with the policy of using surpluses to improve benefits, effectively prevents the employers (i.e. the taxpayer) from gaining any direct benefit from a surplus.

An argument advanced to us in discussions is that benefit improvements in OMERS over the past decade or so were intended to bring OMERS benefits into line with other public sector plans. To this degree, it is argued, the benefit improvements were in the interest of employers (as well as plan members) as a means of achieving competitive total compensation. Whether or not this argument was valid in the past, OMERS benefits are now considered by some to be equivalent to other public sector plans.

We note that to the extent that a surplus is not distributed, it provides a contingency reserve or cushion against future actuarial or investment risk deficits. In our view, it would be prudent to leave at least part of an actuarial surplus or investment risk surplus in the OMERS Fund as a contingency reserve, since the surplus of $569 million represented less than 7 per cent of the assets of the OMERS Fund as of December 31, 1986.

This leaves unanswered the question: who should be responsible for an actuarial deficit if actuarial assumptions are wrong?

Some union representatives have argued that history shows there is a much greater chance of there being an actuarial surplus in a pension fund than a deficit because actuaries use very conservative assumptions. This is another way of arguing that the employees' contribution rate is usually set too high. There appears to be some basis for this argument in the case of OMERS, since the increase in employer and employee contribution rates in 1978 was higher than necessary to fund the liabilities at that time. OMERS has had a surplus since 1981.

As noted earlier in Figure 10.7, the OMERS Fund had a deficit only in 1978, 1979 and 1980 of the ten years between 1976 and 1985. However, when the contribution rates of employers and employees were increased to 7.0 per cent in 1978 as a result of the move by OMERS to a highest average earnings formula, the actuary and the OMERS Board concluded that, in spite of the deficit, the new contribution rates were adequate to fund the plan without difficulty for the foreseeable future. Additional employer contributions to amortize the deficit therefore were not required. This could be interpreted as employees sharing the cost of the deficit.

The responsibility for deficits in a defined benefit related deal rests with the employer and, in our view, should continue to do so.

The OMERS Board in its brief does not explicitly address surplus ownership but states that its role with respect to the pension fund is "to manage and invest the

monies entrusted to us solely for the benefit of our present and future members."[10] The Board also notes that improvements to pension benefits have been made possible "by sound and stable financial planning and because of the strong investment performance of the OMERS fund."[11]

We do not support the OMERS practice of providing the benefit of any distributed surplus only to plan members, with no reduction in employer contribution rates. We view this practice as detrimental to the interest of taxpayers.

Pension Fund Structure and Control

Representatives of employees appear very satisfied with the structure of OMERS and the extent of representation of plan members on the OMERS Board. However, they would prefer to select and appoint their own Board members rather than have them appointed by the Lieutenant Governor in Council.

The OMERS Board notes that its structure is unique in the pension world in that a majority of the members of the Board are employees.[12]

We are of the view that, in terms of the formal pension deal and taking into account the fact that employers remain responsible for any deficit, plan members have more representation on the Board than is warranted. If employees fully shared the cost of any deficiency with employers, a 50 per cent representation of employees would be appropriate.

The Task Force also notes that all Board members have the same fiduciary duty to care for the interests of all those whose interests are affected (including both employers and plan members) regardless of which interest group they belong to (see Chapter 3).

Centralization of Pension Funds

All who submitted briefs and who commented on this issue favour keeping OMERS separate from other large funds. We support this position for reasons set out in Chapter 4.

The OMERS Board does suggest, however, that some centralization of investment management for small public sector pension funds would permit greater efficiencies.[13]

Investment Policy

The OFL and other representatives of plan members are very supportive of OMERS' investment performance.

[10] OMERS Brief, covering letter from C.M. Beckstead, Chairman, page 1.

[11] OMERS Brief, page 1.

[12] OMERS Brief, page 1.

[13] See OMERS Brief, page 2.

The OFL makes two proposals relating to investment policy in general:

- First, it argues that ethical and social objectives can and should be pursued, without impairing either the security or the earnings of pension funds, provided the objectives sought are those of plan members. It urges that the fiduciary responsibilities of pension fund trustees should be defined in legislation so as to provide for this.[14] We deal with this topic in Chapter 5.

- Second, it proposes that the Government establish new investment vehicles, with competitive interest rates and government guarantees, to enable pension funds to make social investments, such as loans for non-profit housing co-operatives or new manufacturing in Northern Ontario.[15]

  As noted in Chapter 5, we agree that where the Government wants to attract pension fund investments in areas of social policy priority, it should provide incentives or guarantees to ensure such investments will be competitive. Pension fund investments should be voluntary, not directed by the Government.

Other representatives of plan members oppose any suggestion that the Government might direct OMERS investments toward economic enhancement objectives. They stress that the OMERS Fund is for the benefit of plan members, not the province as a whole.

The OMERS Board makes the following points with respect to investment policy:

- Investing in the capital markets has been a major reason for OMERS' rapid growth and successful performance.

- While economic enhancement is not the purpose of OMERS, the OMERS Board believes it has contributed to economic enhancement through successful market investments.

- As noted in Figure 10.5, OMERS has diversified its investments into non-traditional areas such as real estate, mortgages, term loans and venture capital. These investments have contributed to a strong investment performance.

- Government should not direct public sector pension funds to make specific investments as part of an economic enhancement program. Government would be better to establish incentive programs which encourage pension funds to invest in a particular area (such as non-profit housing). We agree with this position.

[14] OFL Brief, pages 26-29.

[15] OFL Brief, pages 31-33.

Process for Changing the Pension Deal

The OFL is critical of the fact that plan members are not able to bargain collectively with respect to the OMERS pension deal. Only supplementary benefits can be negotiated with individual employers.

The Task Force feels that a clear link between pension benefit decisions and salary decisions is desirable, whether through collective bargaining or some other means. The present arrangement whereby OMERS deals with benefit levels and improvements and employers deal with salaries has the disadvantage that no one is clearly responsible for total compensation decisions. See Chapter 3, Section IX, for our general comments on the process for changing the pension deal.

Many associated with OMERS have raised objections to the requirement for approval of benefit changes by the Lieutenant Governor in Council. They particularly object when benefit improvements approved by the OMERS Board are turned down by the Government, as has happened on some occasions.

We note that amendments have recently been approved to other legislation whereby closed municipal plans (pre-OMERS) no longer require government approval to change benefit levels. The only clear difference between such closed municipal plans and OMERS is that for the former, municipal councils are the decision-makers on benefit changes and they clearly are expected to represent the taxpayer's interest. Such representation is not as evident in OMERS. We are not in a position to determine whether in fact municipal councils do protect the taxpayer's interest on pension matters in these closed plans.

It is our view that, under the current pension deal, the Government approval requirement is appropriate. If a new deal is put in place, whereby plan members share the risk, the Government approval requirement may not be as necessary.

Summary

Figure 10.10 summarizes the comments of the OFL and other plan member representatives and sets out the Task Force's response.

Summary of Comments by the OFL and Task Force's Response

OFL Comments	Task Force Response	Comments
Employer should guarantee pension benefit	Agree	Consistent with pension deal
Employers' contributions should not fall below employees' contributions	Do not agree	Variable employer contribution rates are consistent with defined benefit pension deal and with OMERS pension deal
Pensions should be indexed to inflation	To be mandatory under Pension Benefits Act, 1987	OMERS has provided ad hoc partial inflation adjustments
OMERS fund surplus belongs to plan members	Do not agree	Plan members do not share OMERS Fund deficit. They may be entitled to share an actuarial surplus
Retain current employee majority on OMERS Board	Do not agree unless deal changed to shared risk/reward deal	Plan members do not share OMERS Fund deficit
OMERS Fund should remain separate from other public sector pension funds	Agree	Fund structure is not an employee decision. Continued separation is desirable for other reasons
Plan members' social objectives should be pursued when consistent with the security and earnings of the Fund	Do not agree	It is a decision for the pension fund governors
Government should not direct OMERS fund investments	Agree	Better for Government to provide incentives to attract investment
Salary and pensions should be negotiated within a total compensation context	Agree	Acknowledge practical difficulty, but needs to be done
Oppose need for Government approval of benefit changes	Do not agree	Government approval could be dropped if deal changed to shared risk/reward deal

FIGURE 10.10

Figure 10.11 summarizes the comments of the OMERS Board and the Task Force's response.

Summary of Comments of OMERS Board and Task Force's Response

OMERS Board Actions and Comments	Task Force Response	Comments
Employers' contributions should match employees' contributions	Do not agree	Variable employer contributions are consistent with defined benefit deal and OMERS pension deal
Distributed surpluses should be used to improve benefits	Do not agree	Plan members do not share OMERS Fund deficit. They may be entitled to share an actuarial surplus.
OMERS Fund should remain separate from other public sector pension funds	Agree	Continued separation is desirable.
Government should not direct OMERS investments	Agree	Better for Government to provide incentives to attract investment.

FIGURE 10.11

Figure 10.12 summarizes our understanding of what the OFL would like in the OMERS pension deal, and what types of deal this assumes.

OFL/CUPE Comments by Type of Pension Deal

Defined Benefit Related Deal	Combined Deal	Asset Related Deal	Independent
Employers should guarantee defined benefit	Employer contributions should not fall below employees' contributions	Surplus belongs to plan members	Pensions should be indexed to inflation
—	Plan members should have at least joint control of OMERS Fund	—	Salary and pensions should be negotiated within a total compensation context
—	—	—	OMERS Fund should remain separate from other public sector pension funds

FIGURE 10.12

The OFL appears to want the best features of both asset related and defined benefit related pension deals, and none of the risks of either. The fact that it wants the employers to match or exceed employee contributions suggests it also wants elements of a combined deal.

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the OMERS pension deal to address problems we have identified and to respond to some comments from the OFL and the OMERS Board.

For the most part, OMERS works well. It provides a common pension benefit to a diverse group of employees. Supplementary benefits can be negotiated, if desired, at an extra cost to the employees and/or employers.

OMERS investment performance has been good. This has enabled the OMERS Board to improve pension benefits and to provide a reasonable level of inflation protection from the surplus of the fund.

On the surface, OMERS is an example of a good pension deal working smoothly. No one is complaining, at least not vigorously.

However, the Task Force believes that the taxpayer's interest is not adequately taken into account. There are three options open to the Government:

- Do nothing on the grounds that OMERS works smoothly and nobody is complaining.
- Change current practice so that it is aligned with the formal pension deal. This would require changing the membership structure of the OMERS Board, changing the way surpluses are used and changing the matching contribution rates.
- Change the formal pension deal so it is aligned with the current practice and explicitly share the risks and the rewards between the taxpayer and plan members.

After weighing the pros and cons of the three options, the Task Force recommends that:

Recommendation 10.1

The Government initiate discussions designed to bring the formal OMERS pension deal into line with current practice but with an explicit sharing of risks and rewards between employer/contributors and plan members.

Specifically this recommendation means:

- The employers' contributions would continue to match employees' contributions.
- Employers and employees would make equal extra payments to finance a deficit in the pension fund (e.g. through jointly higher contribution rates as required).
- Inflation indexing and benefit improvements would be financed out of surplus assets or matching contributions by employers and employees. (But another means would have to be found for taxpayers to share in a surplus.)

- The OMERS Board would have equal representation from employers and plan members (including beneficiaries).
- The Government may no longer need to be represented on the Board.
- There would be no explicit or implicit Government guarantee of the pension promise.
- Approval by the Lieutenant Governor in Council of benefit changes would no longer be necessary. (We note that the requirements of the Pension Benefits Act would still apply.)
- The Government still would be the plan sponsor, would appoint members to the Board and would make any legislative changes required to change the pension deal.

If Recommendation 10.1 is not accepted, then the Task Force recommends:

Recommendation 10.2

As an alternative to Recommendation 10.1, current practice in the OMERS pension deal should be changed to bring it into line with the formal OMERS pension deal.

Specifically this recommendation means:

- The number of employer representatives on the Board should be increased so that employer representatives are a majority. This, in turn, would require consideration being given to how employer representatives are chosen.
- Employers' contributions should be variable as set out in legislation, allowing the employers (i.e. the taxpayer) to benefit from any surplus.
- A more explicit and direct link should be forged between pension benefits and employee salaries and other fringe benefits so that the taxpayer is aware of the total cost of compensation paid to employees who are part of OMERS. (As it stands now, there is no such link. The OMERS Board makes recommendations with respect to pension benefits which are then ratified or rejected by the Government.)

Pensions for Municipal Councillors

One issue raised with us on many occasions is the proposal to enhance pension benefits for municipal councillors, similar to the existing arrangement for Members of the Legislative Assembly and Members of Parliament.

While this issue is beyond our terms of reference, we would be concerned if the pension fund monies for such enhanced benefits were merged with the OMERS Fund, because cross-subsidies with the general OMERS membership could result.

To avoid such cross-subsidies if a new formula is introduced for municipal councillors, it would be desirable in our view to separate the pension monies for municipal councillors from the main OMERS Fund. OMERS could continue to manage such a separate account, but the account would be valued and funded on its own.

SECTION IV

CAATS

This section reviews the plan administration and investment management relationship between OMERS and CAATS.

The Colleges of Applied Arts and Technology (CAATS) pension plan serves employees of 22 community colleges. When the community college system was established consideration was given to including community college employees in the PSSF. This was rejected in favour of setting up a separate pension plan and treating community college employees as staff of independent crown corporations. OMERS was asked to administer the plan and plan assets, under section 16 of the OMERS Act.

Figure 10.13 provides an overview of the CAATS Fund.

Overview of the CAATS Fund

December 31, 1986

Fund	Sector	Assets ($ Million)	Rank by Assets	Employers	Active Plan Members	Benefi-ciaries	1986 Cash Flow* ($ Million)	Surplus* (Deficit) ($ Million)
CAATS	Educa-tion	860	7	22	15,655	1,607	133	59

* Calculated as a pro rata share of OMERS based on CAATS assets in proportion to total assets.

FIGURE 10.13

As of December 31, 1986, the CAATS plan had 15,655 active members, 1,607 beneficiaries and assets of about $850 million. In terms of assets, the CAATS Fund is Ontario's seventh largest public sector plan fund. Its cash flow in 1986 was about $133 million. The CAATS Fund had a surplus of $59 million as of December 31, 1985.

The CAATS pension deal was not established by separate legislation. Rather, it was established under the Pension Benefits Act, like HOOPP and most other public sector pension plans.

Figure 10.14 summarizes the roles and responsibilities of the various parties to the CAATS pension deal.

CAATS Roles and Responsibilities

Sponsor	Employer	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
Council of Regents*	Community Colleges*	Community Colleges	None Designated (Implicitly OMERS)	None Designated (Implicitly OMERS)	OMERS	OMERS

* See Roles of Participants below.

FIGURE 10.14

Roles of Participants

There is some confusion as to who is the plan sponsor and the employer for pension purposes.

The Board of Governors of each community college is the legal employer. However, the provincially-appointed Council of Regents establishes the rules of employment for community colleges.[16] The Council is the plan sponsor of the CAATS plan. OMERS acts as trustee and administrator of the CAATS plan under contract to the Council of Regents.

The CAATS plan is set up so that, if any element is changed, the management agreement with OMERS also must be changed. Since this requires an order in council under the OMERS Act, the Government effectively controls changes to the CAATS pension deal.

In this sense the Government is ultimate plan sponsor of the CAATS pension deal with the Council of Regents acting as a link in the approval chain.

Each community college makes employer contributions to the CAATS Fund. No custodian or trustee has been appointed. However, these functions are performed by OMERS under contract to the Council of Regents. OMERS is also investment policy maker and investment manager.

Relationship of the Participants

Figure 10.15 illustrates the relationship among the various parties involved in the CAATS pension deal.

[16] The Council of Regents is appointed by the Lieutenant Governor in Council to assist the Minister in the planning, establishment and co-ordination of programs of instruction and services for the CAATS.

CAATS Structure and Decision-Making Relationships

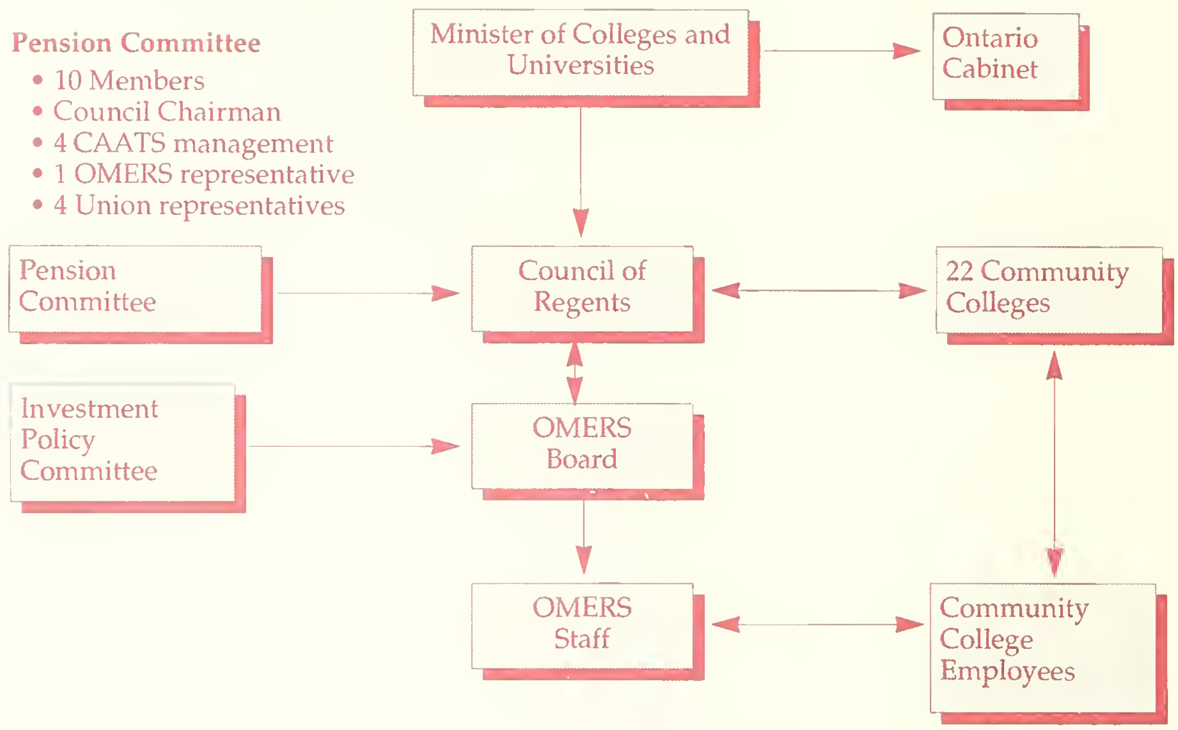


FIGURE 10.15

The Council of Regents has established a 10-member Pension Committee with six representatives from management, including the Council Chairman and an OMERS representative, and four from the Ontario Public Service Employees Union (OPSEU) which represents most but not all CAATS employees.

The mandate of the Pension Committee is:

- to keep plan design current and responsive to the needs of the organizations and their employees
- to review and ensure funding adequacy
- to review and monitor investment performance
- to review and find solutions to individual members' complaints.

CAATS assets are pooled with OMERS and Ryerson assets for investment purposes. Asset mix decisions are made exclusively by OMERS. The Pension Committee makes recommendations to the Council of Regents on matters of policy and endeavours to work with OMERS in the resolution of problems relating to plan administration, such as benefit entitlements of individual plan members.

Growth of the CAATS Fund

The growth of the CAATS Fund is illustrated in Figure 10.16.

Growth of CAATS: 1970-1985

Year	Assets * ($ Million)	Active Plan	Annual Contributions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1970	9.9	6,107	5.4	29	0.03
1975	74.5	11,307	17.2	151	0.13
1980	248.4	13,179	30.1	584	1.1
1986	776.4	15,655	55.6	1607	6.5

* Book value

FIGURE 10.16

Since 1970, assets have increased by over 77 times, the number of active plan members has more than doubled, the number of pensioners has increased 55 times and the annual pension benefits paid have increased by over 2,100 times.

Relationship with OMERS

The relations between CAATS and OMERS are strained. CAATS are unhappy with the quality of service provided by OMERS. There is also the belief that CAATS assets are large enough, and the OMERS asset mix possibly different enough from that appropriate for CAATS, to justify a separate fund. OPSEU supports a separate fund.

A consultant hired by CAATS recommended in 1986 that a separate CAATS fund be established.

In brief, CAATS are of the view that:

- Plan administration responsibilities for CAATS should be removed from OMERS and an insurance company asked to provide the service.
- Investment management responsibilities for CAATS should be removed from OMERS and a separate CAATS fund with its own independent Board should be established.

The desire to terminate the contract with OMERS appears to relate almost entirely to the perceived quality of plan administration services provided by OMERS. The preference of CAATS to establish a separate CAATS fund results not from any dissatisfaction with OMERS investment performance or the belief that a CAATS investment management team could earn a higher rate of return, but from a view that CAATS should control their own assets.

OMERS Views

In response to the CAATS concerns, OMERS staff indicate:

- that their service to CAATS in 1986 was poor. However, they state that they have taken steps to improve their service, including setting up a separate section to deal with CAATS plan administration needs.
- that OMERS is phasing in a new computer system which will make it easier to service the separate and different plan administration needs of CAATS.

- that OMERS never sought to be a supplier of services to any outside organization. In effect, its supplier role was "mandated" by government.
- that the relationship between CAATS and OMERS is a contractual relationship only. If CAATS want to leave and take their business elsewhere, it's up to them.
- that in the past the OMERS Board has had little interest in being a supplier of pension administration services. Its first priority has been to provide plan administration and investment management to OMERS members.
- that OMERS is reviewing its mission and the OMERS Board will be asked directly if it wants to be in the "supplier business."
- that given the wide asset mix in which OMERS invests, including real estate, it would be difficult to invest CAATS assets in a segregated fund rather than pooling the CAATS assets with OMERS assets as is currently the case.
- that a segregated fund administered by OMERS is possible but that such an arrangement is undesirable because it could result in perceived conflicts of interest within OMERS and could give CAATS a veto over specific investments, slowing down decision-making, thereby affecting the investment process. As well, it would be more expensive than the current arrangement.
- that OMERS has difficulty dealing with CAATS on pension matters and believe that CAATS, the Council of Regents and the Ministry of Colleges and Universities need to get their pension house in order so there is a uniform voice presented as the "buyer" of the pension service. There are 22 colleges, a Council of Regents and the Ministry of Colleges and Universities to deal with.
- that CAATS needs to have an appreciation of its pension liabilities to ensure that investment policies are reasonably aligned.

Four Options

CAATS have grounds for dissatisfaction with the quality of the plan administration service provided by OMERS.

There appear to be at least four ways to proceed in the future:

Option I: Maintain the status quo (i.e. total delegation of plan administration and investment management to OMERS).

The present contractual relationship would continue but with OMERS providing improved plan administration service (OMERS would be expected to be competitive with other suppliers), and better investment information to CAATS. The pooling of CAATS assets with OMERS assets would continue.

Option II: Partial delegation by CAATS to OMERS.

The present contractual relationship would be modified so that OMERS competes with other suppliers of plan administration services for CAATS business, and CAATS determine the investment policy for their assets, with OMERS implementing the strategy. This would mean segregating CAATS assets.

Option III: OMERS ceases to supply plan administration services to the CAATS but retains the responsibility for investment management either on a pooled or segregated basis.

Option IV: Cancel the OMERS/CAATS contract and let CAATS establish their own structure.

Conclusions and Recommendations

Option I is still a realistic alternative even with the degree of dissatisfaction CAATS feel over the current service. However, this option would require OMERS to demonstrate in no uncertain terms that it is a dependable supplier. There is some evidence that OMERS is taking steps to improve its performance. Even so, there appears to be some ambivalence, at least at the OMERS Board level.

In any event, it would be inappropriate to sever the CAATS/OMERS relationship **until**[17]:

- the identity of the employer in CAATS is clearly determined. There are three possible candidates – the individual community colleges, the Council of Regents, or the Ministry of Colleges and Universities. At present, there is a blurring of roles and responsibilities among these bodies which needs to be clarified before any change is made in the OMERS relationship.
- the cost implications of severing the relationship with OMERS are identified.
- the OMERS Board has decided whether OMERS should be in the supplier business.

There is no evidence that shifting the investment management responsibilities from OMERS would be beneficial to CAATS from a rate of return point of view.

Option II is not feasible from OMERS' standpoint, as it would mean segregating CAATS assets from OMERS assets. This would create rigidities in investment decision-making.

Option III with investment management on a pooled basis is a possibility and should by carefully evaluated before Option IV is pursued.

Recommendation 10.3

The Ministry of Colleges and Universities, the Council of Regents and the Boards of Governors of the Colleges of Applied Arts and Technology (CAATS) should clarify their different roles and responsibilities with respect to the CAATS pension deal in order to confirm, among other things, who is the employer for pension purposes, who is the plan sponsor and who is responsible for unfunded liabilities.

[17] These conclusions and subsequent recommendations are reinforced by the comments of Walter Pitman in *The Report of the Advisor to the Minister of Colleges and Universities on the Governance of the Colleges of Applied Arts and Technology*, June,1986.

Recommendation 10.4

No change should be made in the contractual relationship between OMERS and the CAATS respecting either plan administration or investment management until:

(a) Recommendation 10.3 has been completed, and

(b) The cost implications of the proposed changes have been assessed.

If it is decided that the Ministry of Colleges and Universities is not the employer and that there is no explicit or implicit guarantee by the Government of CAATS pensions, then the decision to retain or change the current contractual relationship with OMERS is the employers' and not the Ministry's.

Shifting the investment management responsibilities to either internal investment managers of a new CAATS fund or, more likely, to external investment managers, will probably reduce the range of non-traditional investments being purchased. This would likely be a retrograde step from an economic enhancement point of view.

Looking at the OMERS/CAATS issue from OMERS' point of view, we recommend:

Recommendation 10.5

The Government should clarify whether Section 16 of the OMERS Act (under which OMERS carries out plan administration and investment management functions for CAATS and RYERSON) is permissive or mandatory. If mandatory, then the Government should set out to whom the OMERS Board is accountable in this respect and how its performance should be measured.

Recommendation 10.6

If Section 16 of the OMERS Act is permissive, the OMERS Board should determine whether OMERS wishes to supply plan administration and investment management services to other public sector pension funds. If it wishes to supply such services, the OMERS Board must be prepared to give direction and support to OMERS staff so that they can provide high quality and competitive service.

SECTION IV

RYERSON

This section reviews the plan administration and investment management relationship between OMERS and RYERSON.

Figure 10.17 provides an overview of the RYERSON Fund.

Overview of the Ryerson Fund

December 31, 1986

Fund	Sector	Assets ($ Million)	Rank by Assets	Employers	Active Plan Members	Benefi-ciaries	Annual Cash Flow* ($ Million)	Surplus (Deficit) ($ Million)
Ryerson	Education	84	28	1	1,210	144	13	6

* Calculated as a pro rata share of OMERS, based on share of assets.

FIGURE 10.17

RYERSON, too, has been unhappy with the plan administration service provided by OMERS but apparently not to the same extent as CAATS. RYERSON is studying its relationship with OMERS but has not reached any decision.

OMERS believes that its better relationship with RYERSON results, in large part, because they have only one point of contact with RYERSON, while dealing with CAATS involves 22 community colleges, the Council of Regents and the Ministry of Colleges and Universities.

At this stage the pressures to sever RYERSON from OMERS are not as great as those related to CAATS. However, should this change, considerations similar to those recommended for CAATS would apply.

In Chapter 9, we recommend that the SAF be merged with the underlying pension plans and funds. For Ryerson this would mean that RYERSON assets now in the SAF would be merged with RYERSON assets now being invested by OMERS.

Conclusion

This chapter has reviewed the OMERS pension deal and found that current practice has evolved away from the formal pension deal to the detriment of the taxpayer.

Either the formal pension deal should be changed to bring it into line with current practice or current practice should be changed to bring it into line with the formal pension deal.

The contractual relationship between OMERS and CAATS was also reviewed. While there are legitimate CAATS complaints, we recommend no change be made until the Government sorts out, among other things, who is the employer and has responsibility for the CAATS pension plan.

CHAPTER 11

ONTARIO HYDRO PENSION FUND (HYDRO)

SYNOPSIS

Current practice is closely aligned with the formal pension deal. A number of improvements could be made to the investment decision-making process of the HYDRO Fund. The Ontario Hydro Board of Directors should review its pension fund structure. The Power Corporation Act should be amended to remove all but the enabling provisions for the HYDRO plan and fund, so that the plan and fund could be administered solely in accordance with the Pension Benefits Act, 1987. This would allow the Ontario Hydro Board to authorize use of external investment managers and custodial services as appropriate. It would also remove the requirement for approval by the Lieutenant Governor in Council of negotiated changes in pension benefits for Ontario Hydro employees.

Introduction

This chapter describes the current pension deal with Ontario Hydro employees. It also reviews the comments expressed by representatives of plan members and by Ontario Hydro and the Task Force's response.

Figure 11.1 provides an overview of the Ontario Hydro pension fund (HYDRO Fund).

Overview of the HYDRO Fund
December 31, 1986

Fund	Sector	Assets* ($ Billion)	Rank by Assets	Employers	Active Plan Members	Benefi-ciaries	1986 Cash Flow ($ Million)	Surplus** (Deficit) ($ Million)
HYDRO	Utilites	3.28	5	1	23,542	7,691	321	399

* Market value
** Actuarial valuation as of December 31, 1985

FIGURE 11.1

The HYDRO Fund is Ontario's fifth largest public sector pension fund, with assets of $3.28 billion as at December 31, 1986. There are over 23,500 plan members and almost 7,700 beneficiaries. Its cash flow in 1986 was over $300 million. The HYDRO Fund had a surplus of almost $400 million as of December 31, 1986.

The chapter is divided into three sections:

- I. **The pension deal**
- II. **Views of plan members and Ontario Hydro**
- III. **Changes needed to the pension deal**

SECTION I

The Pension Deal

Roles of Participants

The HYDRO pension deal is set out in the Power Corporation Act, in the regulations under that Act, and in the collective bargaining agreements between Ontario Hydro and its employees.

Figure 11.2 summarizes the roles and responsibilities of the various parties to the HYDRO pension deal.

HYDRO Fund Roles and Responsibilities

Sponsor	Employer	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
Ontario Hydro	Ontario Hydro	Ontario Hydro	Ontario Hydro (Implicit)	Ontario Hydro (Implicit)	Ontario Hydro Board	Ontario Hydro Staff

FIGURE 11.2

Ontario Hydro sponsors the HYDRO pension deal. While no custodian or trustee has been appointed, the Ontario Hydro Board implicitly has these responsibilities. It is also the investment policy maker. Investment management is assigned to a Hydro staff group.

Relationship of Participants

Figure 11.3 illustrates the relationship among the various parties involved in the HYDRO pension deal.

HYDRO Fund Structure and Decision-Making Relationships

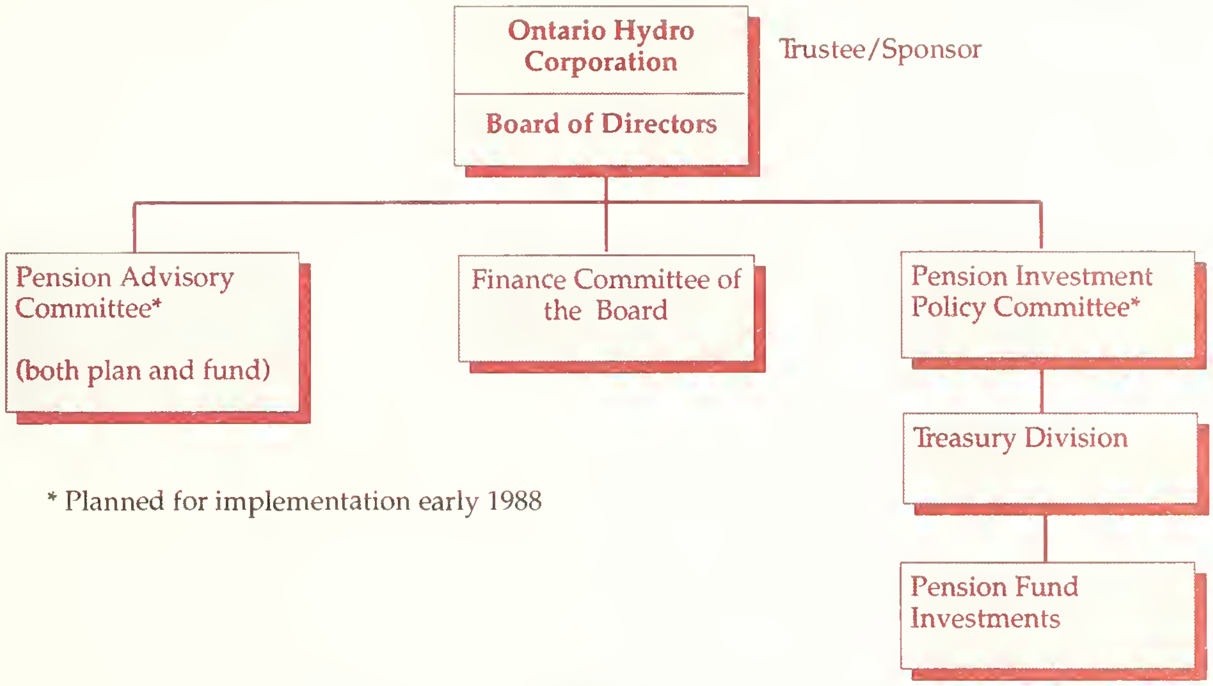


FIGURE 11.3

The Ontario Hydro Board relies on its Finance Committee to provide advice and guidance regarding the activities of the HYDRO Fund.

The Finance Committee makes recommendations to the Board on asset mix and on the quarterly investment program. The Board has final approval.

The Board intends to establish a Pension Investment Policy Committee, as shown in Figure 11.3, to assume responsibility from the Finance Committee for all pension matters.

The Board also intends to establish a pension advisory committee made up of representatives of plan members, including retirees, in accordance with section 25 of the Pension Benefits Act, 1987.

Plan members are not involved in investment decision making. Ontario Hydro's rationale for this is that the pension plan is a defined benefit plan and, since employees have no risk, they should have no say in investment decisions.

All investments are required by the Power Corporation Act to be internally managed. Investment management is by Ontario Hydro's Treasury Division.

Investment Policy

The primary purpose of the HYDRO Fund is to meet the obligations of the HYDRO plan. The investment objective of the HYDRO Fund is to maximize the long term rate of return on assets, given existing legal and investment policy constraints.

The HYDRO Fund is invested in market investments within the constraints established by the Pension Benefits Act and by the Ontario Hydro Board.

Figure 11.4 summarizes the HYDRO Fund's investment portfolio in 1986.

Percentage of Assets by Category in 1986

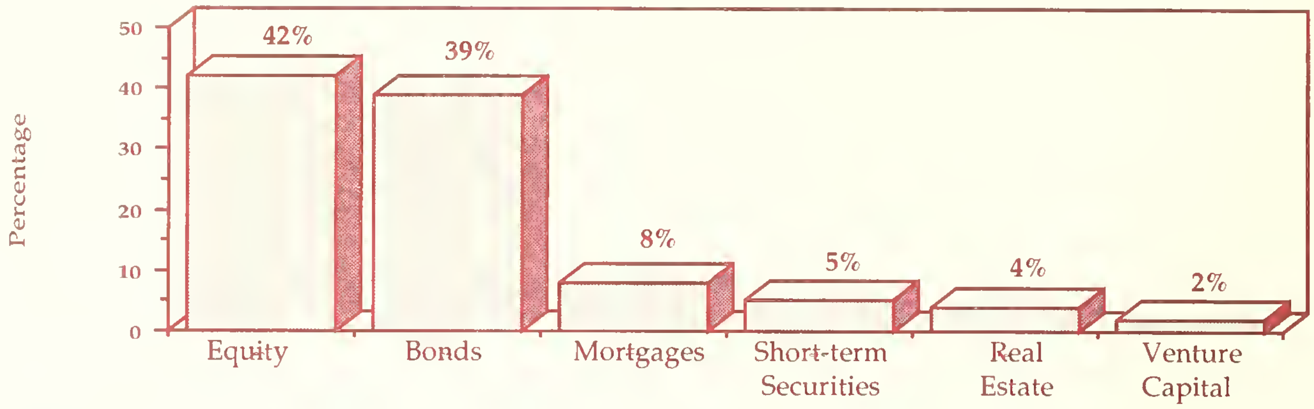


FIGURE 11.4

Growth of the Fund

The growth of the HYDRO Fund is illustrated in Figure 11.5.

Growth of the Hydro Fund: 1965–1986

Year	Assets[1] ($ Billion)	Active Plan Members	Annual Contri-butions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1965	0.175	11,850 [2]	8.0	1,592 [2]	3.6
1975	0.500	19,488 [3]	59.8	3,967 [3]	15.1
1980	1.284	22,478	67.2	4,934	33.8
1986	2.697	23,542	57.7[4]	7,691	85.2 [4]

[1] Book value
[2] 1964 data
[3] 1976 data
[4] 1985 data

FIGURE 11.5

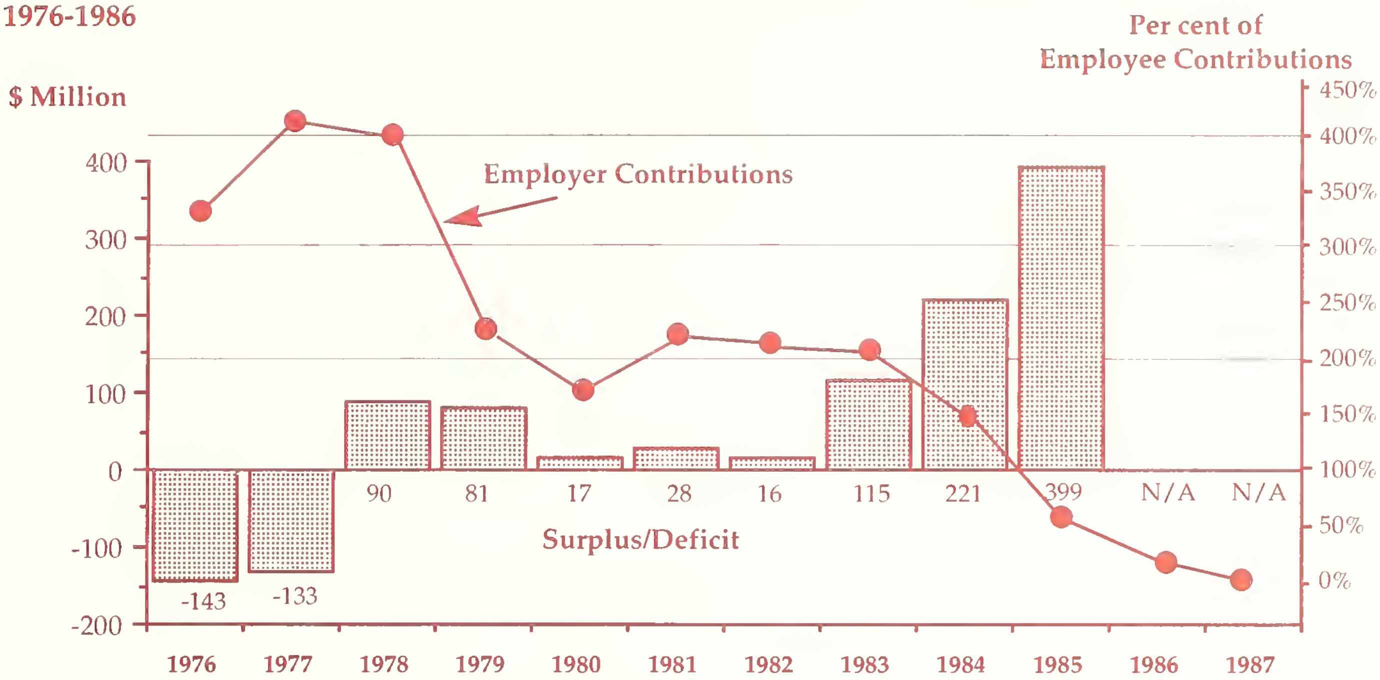
Since 1964, HYDRO Fund assets have increased by over 15 times, the number of active plan members has almost doubled, the number of beneficiaries has increased by over four times and annual pension benefits paid have increased by over 23 times.

Record of Surpluses/Deficits and Employer Contribution Rates

Figure 11.6 illustrates the record of surpluses and deficits in the HYDRO Fund since 1976, and the employer contributions as a percentage of employee contributions each year over the same period.

Comparison of the HYDRO Surplus (Deficit) and the Employer Contributions as a Percentage of Employee Contributions

1976-1986



Source: Public Sector Pensions Advisory Board Staff and Ontario Hydro

FIGURE 11.6

The HYDRO Fund had a deficit in 1976 and 1977. Since 1978, it has had a surplus, which rose to $399 million in the actuarial valuation as of December 31, 1985. During this period, Ontario Hydro made contributions above the level of employee contributions in all years except the last three, peaking at 430 per cent of employee contributions in 1977.

In 1987, in view of the continuing surplus in the HYDRO Fund, Ontario Hydro has reduced its contributions to zero.

Formal Pension Deal vs Current Practice

Figure 11.7 compares the formal pension deal for Ontario Hydro employees with current practice and identifies areas of difference (represented by the shaded areas).

HYDRO ~ Formal Pension Deal

Kind of Deal	Benefit Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit	2% per year of service based on best 5 years	Employee: fixed	Surplus: ongoing surplus not stated**	Market investments	Plan Administration: Employer *	Legislation & Collective bargaining & Cabinet approval
		Employer: variable	Deficit: employer		Investment Management: Employer	

* Ontario HYDRO plans to establish a pension advisory committee to provide for plan member input.
** Surplus reverts to the employer if the plan is terminated.

HYDRO ~ Current Practice

Kind of Deal	Benefit Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit	2% per year of service based on best 5 years & ad hoc inflation	Employee: fixed	Surplus: ongoing surplus shared**	Market investments	Plan Administration: Employer *	Legislation & Collective bargaining & Cabinet approval
		Employer: variable	Deficit: employer		Investment Management: Employer	

* Ontario HYDRO plans to establish a pension advisory committee to provide for plan member input.
** Surplus reverts to the employer if the plan is terminated.

FIGURE 11.7

The **formal pension deal** can be summarized as follows:

- The pension deal is a defined benefit related deal.
- The pension benefit is determined by a formula based on a combination of years of service and the average salary earned in the best five years of service.
- The employees make fixed contributions to the fund of 5 per cent of salary above the CPP maximum earnings level. The employer makes variable contributions based on what is needed to keep the fund actuarially sound.
- The employer is responsible for any deficit.
- Who owns an ongoing surplus is not stated. A surplus on termination belongs to the employer.
- Investment policy, investment management and plan administration is the responsibility of the Hydro Board.
- Benefit changes are usually determined by collective bargaining with the Canadian Union of Public Employees (CUPE) Local 1000 which represents a majority of, but not all, HYDRO plan members. Any benefit changes are subject to approval by the Lieutenant Governor in Council.

- Fundamental changes to the HYDRO pension deal require amendments to the Power Corporation Act.

Current practice differs from the formal pension deal in two ways:

- First, Ontario Hydro has made a practice of providing ad hoc inflation increases to retired employees and their beneficiaries although this is not part of the formal pension deal.

- Second, although the formal deal does not state who owns an ongoing surplus, Ontario Hydro has used part of the ongoing surplus to pay for ad hoc inflation adjustments and for benefit improvements for active plan members. This is an allocation of some of the surplus to plan members. At the same time, Ontario Hydro has reduced its contribution rate (to zero in 1987). This action is consistent with the formal pension deal. It has the effect of using some of the surplus to the benefit of the employer.

Ontario Hydro does not believe that using part of the ongoing surplus to pay for benefit improvements and ad hoc inflation increases should be interpreted as sharing the surplus. They point out that in the 1970's, when the HYDRO Fund was in deficit, the employer made substantial additional contributions to pay for benefit improvements and ad hoc inflation increases.[1]

Ontario Hydro feels that the employer alone is entitled to any surplus. See Section II for a further discussion of this issue.

Problems with the Formal Pension Deal

The Power Corporation Act states that the HYDRO Fund will be maintained and administered by the Ontario Hydro Corporation. The Ontario Hydro Board has received legal advice that the Corporation, and not the Board of Directors, is the effective trustee of the HYDRO Fund.

The Act also provides that the business and affairs of the Corporation (including administration of the Fund) shall be under the direction and control of the Board. The Board's legal advice is that the Board is not empowered to delegate policy decisions related to the HYDRO Fund but may delegate administrative decisions.

Four problems arising from these legal provisions and interpretations are as follows:

- There is some ambiguity over the fiduciary obligations of the Board of Directors with respect to the HYDRO Fund, given that it is the Corporation which is the effective trustee.

- The extent to which the Board can delegate investment decision-making is unclear. It is probable that the Board itself must approve investment policy but may delegate investment management.

- Given that the Corporation is both employer of active plan members and trustee of the HYDRO Fund, there could be a perceived conflict of interest for the Corporation in carrying out these two roles.

[1] Ontario Hydro Brief, Submission to the Task Force on the Investment of Public Sector Pension Funds, March 13, 1987, page 4.

- The Act does not permit Ontario Hydro to appoint external investment managers or external custodial/trustee services.

SECTION II

Views of Plan Members and Ontario Hydro

This section reviews comments received from Ontario Hydro and the OFL, and the Task Force's response.

The OFL's submission was made on its own behalf and on behalf of other public sector unions, including CUPE. (CUPE Local 1000 represents most Ontario Hydro employees.)

The comments received from the OFL for the most part were not directed specifically to the HYDRO Fund. As a result, we have exercised judgement in relating their comments to the HYDRO Fund.

The comments fall into the following categories:

- employer guarantee of defined benefit
- employer contribution rates
- inflation indexation
- ownership of a surplus (deficit)
- pension fund structure and control
- centralization of pension funds
- investment policy

Employer Guarantee of Defined Benefit

The current HYDRO pension deal is a defined benefit related deal and includes the employer's guarantee of the pension benefit.

The OFL favours retention of a defined benefit plan (as opposed to a defined contribution plan) because it believes the employer has a higher tolerance for risk than do the plan members. In the OFL's view, the employer should guarantee the pension promise and pay for any deficit in the pension fund but not have access to any pension fund surplus, no matter how derived.

The OFL states that a pension deal of this kind is "just good policy." Indeed, even if collective bargaining is unable to produce this kind of deal, the OFL says that legislative remedies would be the next logical step.[2]

The Task Force does not endorse the OFL's position. Among other things, the OFL position ignores two essential points:

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[2] Based on a meeting with the OFL, August 21, 1987.

- whether the individual employee does or does not have a higher tolerance for risk than the individual taxpayer has not been demonstrated.
- even if it is true that taxpayers, either individually or collectively, have a higher tolerance for risk, it does not follow that taxpayers should be asked to bear a disproportionate amount of risk.

Public policy may ultimately support the OFL's point of view. Before it does, we would point out the very high cost to the taxpayer if such a policy is applied to public sector pension plans.

Ontario Hydro notes that undue regulation or control may penalize defined benefit plans and influence sponsors to choose defined contribution plans in the future.

Employer Contribution Rates

The OFL states that "public sector unions believe that employer contribution rates should never be allowed to fall below the prior year's rate of contribution (and) in no event should employer contributions ever be allowed to fall below employee contributions when the plan is contributory."[3]

Ontario Hydro's view is that the employer's contributions are variable and depend on the level of assets relative to liabilities at a point in time. During the 1970's, Ontario Hydro made substantial additional contributions to the HYDRO Fund due in large part to higher than assumed salary increases. Now that the HYDRO Fund is in surplus, Ontario Hydro has cut back its contributions.[4]

As noted, the legality of Ontario Hydro taking a contribution holiday is before the courts. The Power Corporation Act contemplates that Ontario Hydro's contributions could be variable.

It should be noted that where an employer has the right under a pension deal to vary its contribution rate (as for Ontario Hydro), the Pension Benefits Act, 1987 may impose constraints on that right. Section 40 of the Act in effect requires that employer contributions plus any investment earnings thereon must add up to at least 50 per cent of the value of a plan member's pension in respect of years after 1986. However, this is not a requirement that the employer's contributions must at all times match the employees' contributions. The calculation required by Section 40 is based on the entire period of a plan member's employment.

Inflation Indexation

The OFL argues that, in conditions of inflation, the pension promise is essentially broken if pensions are not indexed. The OFL also notes that "surpluses of most pension plans arise precisely because the real value of benefits are eroded."[5]

Ontario Hydro points to a record of providing periodic ad hoc inflation adjustments. However, such adjustments are at the discretion of the Ontario Hydro Board. No promise has been made to plan members that they will be made in the future.

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[3] OFL Brief, page 21.

[4] Ontario Hydro Brief, page 4.

[5] OFL Brief, page 21.

We note that mandatory inflation indexing is to be implemented under the Pension Benefits Act, 1987. The Task Force on Inflation Protection for Employment Pension Plans is addressing the means by which it can be implemented.

Ownership of a Surplus (Deficit)

Ontario Hydro's position is that it is entitled to reduce its contributions if a surplus arises, just as it is obliged to make additional contributions if a deficit arises. If the surplus is substantial, Ontario Hydro's position is that it is entitled to reduce its contributions to zero (i.e. have a contribution holiday).

The OFL argues that a surplus in a pension fund should be used to improve the benefits of active plan members, to provide inflation protection for pensioners and their beneficiaries and to extend coverage to other workers.

The issue of a contribution holiday by Ontario Hydro has been challenged by CUPE Local 1000 in the Ontario courts.

The initial decision, which supported the legality of Ontario Hydro's position, has been appealed. Given the pending court review, it would not be appropriate for the Task Force to comment on the legality of a contribution holiday by Ontario Hydro.

In Chapter 3 we noted that a surplus can have two parts:

- an investment risk surplus, and
- an actuarial surplus.[6]

This distinction is useful in thinking through which party or parties may be entitled to which parts of a surplus, although the assumptions underlying an existing actuarial surplus may not have been structured so as to assist in allocating it.

There is a plausible argument, in the context of a contributory defined benefit pension deal, that plan members may be entitled to a share of an actuarial surplus. This argument is based on the view that, if employee contribution rates are determined, explicitly or implicitly, on the basis of conservative (as opposed to best estimate) actuarial assumptions, leading to an actuarial surplus, employees are entitled to that part of the actuarial surplus that results from their over-contributions.

Ontario Hydro rejects the notion that the contribution rate of its employees is derived in any way from actuarial assumptions. While the Task Force has no way of verifying the linkage between the HYDRO Fund's actuarial assumptions and employee contribution rates, we believe such a linkage should not be ruled out. Nor should the employees' right to share in an actuarial surplus to the extent of their over-contributions be ruled out. Further, the employer also is entitled to the part of the actuarial surplus resulting from employer over-contributions.

The taxpayer alone (i.e. electricity consumer) should be entitled to any investment risk surplus if it is clear that he bears the burden of any deficit. Since plan members do not share directly in the investment risk, in our view they are not entitled to share in any investment risk surplus.

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[6] An investment risk surplus (or deficit) results from adopting an investment policy with a level of risk above that related to an investment policy that is essentially risk free.

An actuarial surplus is the remainder of any surplus and results from actual experience being better than the actuary assumed.

We note that to the extent that a surplus is not distributed, it provides a contingency reserve or cushion against future actuarial or investment risk deficits. In our view, it would be prudent to leave at least part of an actuarial surplus or investment risk surplus in the HYDRO Fund as a contingency reserve. The $399 million surplus in the Fund as of December 31, 1985 represented only 12 per cent of the Fund's assets as of December 31, 1986.

This leaves unanswered the question: who should be responsible for an actuarial deficit if actuarial assumptions are wrong?

Some union representatives have argued that history shows there is a much greater chance of there being an actuarial surplus than a deficit because actuaries use very conservative assumptions. This is another way of arguing that the employees' contribution rate is usually set too high.

While this argument may be correct, history also shows that employers have had to make considerable extra payments to cover deficits which arose, at least in part, because actuarial assumptions were wrong (i.e. experience deficiencies). See Figure 11.6.

The responsibility for such deficits in a defined benefit related deal rests with the employer and, in our view, should continue to do so.

Pension Fund Structure and Control

The OFL states that, "the minimum position acceptable . . . is joint trusteeship in any plan where the unions so desire."[7] It is not clear how this position could be implemented in a situation such as Ontario Hydro where there is not a separate pension fund board. Even if there were a separate pension fund board, given the nature of the current pension deal, the Task Force endorses only minority representation of plan members, not joint trusteeship.

Ontario Hydro's position is that, although employees have the right to information about the HYDRO Fund, that right does not extend to being involved in managing the investments.[8]

Our view is that some plan member involvement in investment decision-making is appropriate and desirable in all cases. The way this is implemented will vary.

Centralization of Pension Funds

Both the OFL and Ontario Hydro are opposed to further centralization of the management of Ontario's public sector pension funds. We support this position, for reasons set out in Chapter 4.

Ontario Hydro does suggest that a degree of consolidation of smaller public sector pension funds, implemented cautiously and gradually, would be beneficial.[9]

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[7] OFL Brief, page 25.

[8] Ontario Hydro Brief, page 6.

[9] Ontario Hydro Brief page 8.

Investment Policy

The OFL makes two proposals relating to investment policy in general:

- First, it argues that ethical and social objectives can and should be pursued, without impairing either the security or the earnings of pension funds, providing the objectives are those of the plan members. It urges that the fiduciary responsibilities of pension fund trustees should be defined in legislation so as to provide for this.[10] We deal with this topic in Chapter 5.

- Second, it proposes that the Government establish new investment vehicles, with competitive interest rates and government guarantees, to enable pension funds to make social investments such as loans for non-profit housing co-operatives or new manufacturing in Northern Ontario.[11]

  As noted in Chapter 5, we agree that where the Government wants to attract pension fund investments in areas of social policy priority, it should provide incentives or guarantees to ensure such investments will be competitive. Pension fund investments should be voluntary, not directed by the Government.

Ontario Hydro's position is that pension fund managers should seek to maximize returns on investments while exercising their fiduciary responsibility to manage investments prudently. Ontario Hydro points out that pension fund investments contribute significantly to economic development.

Ontario Hydro opposes the Government expecting pension funds to forego investment returns for the purpose of social and economic objectives.[12] We agree with this position.

Summary

Figure 11.8 summarizes the comments of the OFL/CUPE and Ontario Hydro and sets out the Task Force's response.

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[10] OFL Brief, pages 26-29.

[11] OFL Brief, pages 31-33.

[12] Ontario Hydro Brief, page 9.

Summary of Comments by OFL/CUPE and Ontario HYDRO and Task Force's Response

OFL/CUPE Comments	Task Force Response	Comments
Employer should guarantee pension benefit	Agree	Consistent with pension deal
Employer's contributions should not fall below employee's contributions	Do not agree	Variable employer contributions are consistent with defined benefit pension deal and HYDRO pension deal
Pensions should be indexed to inflation	To be mandatory under Pension Benefits Act, 1987	HYDRO has provided ad hoc partial inflation adjustments
HYDRO Fund surplus belongs to plan members	Do not agree	Plan members do not share HYDRO Fund deficit. Employees may be entitled to share an actuarial surplus
Employees should have joint control of HYDRO Fund	Do not agree (but minority representation of plan members should be provided)	Employees do not share HYDRO Fund deficit
HYDRO Fund should remain separate from other public sector pension funds	Agree	Fund structure is not an employee decision. Continued separation is desirable for other reasons
Plan members' social objectives should be pursued when consistent with the security and earnings of the fund	Do not agree	It's a decision for the pension fund's Governors
Government should not direct HYDRO Fund investments	Agree	Better for Government to provide incentives to attract investment
Salaries and pensions should be negotiated within a total compensation context	Agree	How to implement is beyond our terms of reference

Ontario Hydro Comments	Task Force Position	Comments
Variable employer and fixed employee contributions should continue	Agree	Consistent with a defined benefit related pension deal and the HYDRO pension deal
No employee involvement in investment decisions *	Do not agree	Some employee involvement appropriate and desirable
HYDRO Fund should remain separate from other	Agree	Continued separation desirable
Government should not direct HYDRO Fund investments	Agree	Better for Government to provide incentives to attract investment

* In compliance with Section 25 of the Pension Benefits Act, 1987, Ontario HYDRO intends to establish a pension advisory committee to provide for plan member input.

FIGURE 11.8

Figure 11.9 summarizes our understanding of what the OFL/CUPE would like in the HYDRO pension deal, and what types of deal this assumes.

OFL/CUPE Comments by Type of Pension Deal

Defined Benefit Related Deal	Combined Deal	Asset Related Deal	Independent
Employer should guarantee defined benefit	Employer contributions should not fall below employees' contributions	Surplus belongs to plan members	Pensions should be indexed to inflation
—	Employees should have at least joint control of HYDRO Fund	—	HYDRO Fund should remain separate from other funds

FIGURE 11.9

The OFL appears to want the best features of both asset related and defined benefit related pension deals, and none of the risk of either. The fact that it wants the employer to match or exceed employee contributions suggests that it also wants elements of a combined deal.

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the HYDRO pension deal to address problems we have identified and to respond to some of the comments of Ontario Hydro and the OFL/CUPE.

Pension Fund Structure and Control

Currently, the Ontario Hydro Board is both the employer and the pension fund governor. In Chapter 4, we recommend that public sector pension funds should be organized, to the extent practical, so that their activities are clearly separate from the employer and employee.

The Task Force is not able to determine to what extent a separation of roles in Ontario Hydro's case is practical. However, a separation might be achieved in either of two ways:

- Establish a pension fund board (separate from the Ontario Hydro Board) which would be responsible for the investment management of the HYDRO Fund. A minority of appointees would be plan members.

- Appoint a trust company as external trustee with full authority to make investment decisions. It would appear that this alternative would not be practical for the HYDRO Fund because of its size.

Either option would require an amendment to the Power Corporation Act.

If separation were found not to be practical, we believe this would in no way diminish the need for plan member involvement in investment decisions related to the HYDRO Fund.

There is no plan member involvement in the HYDRO Fund at present. We were advised that Ontario Hydro intends to establish a pension advisory committee dealing both with the HYDRO plan and the HYDRO Fund. This would be consistent with the Pension Benefits Act, 1987. However, the committee would not be directly responsible for pension fund decision-making.

We were also advised that Ontario Hydro intends to establish a pension investment policy committee but does not intend to involve plan members. We believe plan members should be represented as this would facilitate communications and enhance employer/employee relations in this area.

Recommendation 11.1

Ontario Hydro should review its pension fund structure:

- **If a separate board is established to be responsible for the investment management of the Ontario Hydro pension fund, a minority of board members should be plan members or their representatives.**
- **If a separate board is not established, a minority of committee members on the planned pension investment policy committee should be plan members or their representatives.**

Constraints in the Power Corporation Act

The Power Corporation Act establishes and sets the framework for the HYDRO pension plan and fund. As noted earlier, the wording of the Power Corporation Act is ambiguous about the fiduciary responsibilities of the Hydro Board and its powers of delegation, and does not permit appointment of external investment managers.

Most public sector pension funds and all private sector funds are not governed by special legislation but are established and operated under the Pension Benefits Act.

Given Ontario Hydro's status as a corporation with a Board of Directors appointed by the Lieutenant Governor in Council, and the fact that pension benefits are bargained collectively as part of total compensation, we do not see the need for the HYDRO plan and fund to be governed directly by the Power Corporation Act.

Recommendation 11.2

The Ontario Hydro pension fund should be governed by the Pension Benefits Act. The specific provisions in the Power Corporation Act covering the HYDRO Fund, apart from any necessary enabling provisions, should be removed.

The effect of this change would be, among other things, to enable the Ontario Hydro Board to delegate investment decision-making and to approve the use of external investment management and custodial services. Whether such action would be taken would be a decision of the Hydro Board.

Approval of Negotiated Benefit Changes

Approval of the Lieutenant Governor in Council is required to ratify changes to pension benefits which have been negotiated through the collective bargaining process. No such approval is needed for salary increases or other compensation changes negotiated at the same time.

In effect, the Government has assumed the final decision-making responsibility for pension benefits collectively negotiated by Ontario Hydro, as employer, with its union.

It is justified for the Government to assume this responsibility only if it is also prepared to reject a duly negotiated collective agreement between Ontario Hydro and its unions and send Hydro back to the bargaining table. This has never been done.

While it is conceivable that the Government might be prepared to reject a collective agreement if the pension benefit provisions were perceived to be inappropriate, the circumstances would likely be extreme. It seems highly unlikely that the Ontario Hydro Board would endorse such a collective agreement in the first place.

In our view, it is more likely that the Government will not reject Ontario Hydro collective agreements even though it may be unhappy with the level of pension benefits negotiated. If this is correct, it suggests that the provision for approval by the Lieutenant Governor in Council is not a logical requirement. This is not to say that the Government should not have the responsibility for monitoring total compensation trends in the public sector. Clearly, it must have that responsibility if it is to be in a position to hold boards of directors to account.

Where trends appear to be getting out of line, the appropriate course for the Government is to anticipate the next negotiation and to have a process for making its views known to the agency concerned, not to try to solve perceived problems after the fact.

Recommendation 11.3

The requirement for approval by the Lieutenant Governor in Council of changes in pension benefits for Ontario Hydro employees should be removed.

Conclusion

This chapter reviewed the HYDRO pension deal and found that current practice is closely aligned with the formal pension deal. The provisions of the Power Corporation Act result in some ambiguities in fiduciary responsibilities and in the power of the Ontario Hydro Board of Directors to delegate responsibilities.

The Act should be amended to remove all but the enabling provisions for the HYDRO plan and fund, leaving it subject solely to the provisions of the Pension Benefits Act, 1987.

CHAPTER 12

HOSPITALS OF ONTARIO PENSION PLAN (HOOPP)

SYNOPSIS

Current practice is closely aligned with the formal pension deal. There should be a more timely adjustment of employers' contributions when the HOOPP Fund has a surplus. When the employers' contribution rate is reduced, the Ministry of Health and the OHA should determine whether hospitals or taxpayers should get the benefit of such a reduction. A minority of the members of the HOOPP Investment Committee should be plan members.

Introduction

This chapter reviews the current HOOPP pension deal. It also reviews the comments of plan members and their representatives and of the Ontario Hospital Association (OHA), and the Task Force's response.

Figure 12.1 provides an overview of the HOOPP Fund.

Overview of the HOOPP Fund
December 31, 1986

Fund	Sector	Assets * ($Billion)	Rank by Assets	Employers	Active Plan Members	Beneficiaries	1986 Cash Flow ($Million)	Surplus ** (Deficit) ($ Million)
HOOPP	Health	3.68	4	301	70,478	19,085	316	274

* Market value.
** Actuarial valuation as of December 31, 1985.

FIGURE 12.1

HOOPP is Ontario's fourth largest public sector pension fund with assets of $3.68 billion as at December 31, 1986. There are over 70,000 plan members and over 19,000 beneficiaries. Cash flow in 1986 was over $300 million. The HOOPP Fund had a surplus of $274 million as of December 31, 1985.

HOOPP is a multi-employer pension plan with 211 hospitals and 90 health-related facilities participating in the plan as of December 31, 1986. The plan sponsor is the Ontario Hospital Association (OHA), a corporation incorporated under the Corporations Act (Ontario).

The OHA contends that HOOPP "is not a public sector plan since its participating employers are private corporations and (its) contributing members are not public servants." The OHA acknowledges, however, "that most employer contributions to the Plan come through global operating budgets allocated by the Ministry of Health out of general government revenues and that "the government . . . has an obvious fiscal interest in the Plan."[1]

Indeed, the cost of employee benefits (including pension contributions) is an allowable item in calculating operating costs for the purpose of determining Ministry of Health grants to hospitals. As well, in the event of a deficiency in the HOOPP Fund, the expectation is that hospitals would look to the Ministry of Health for additional money. On average, the Ministry of Health provides each hospital with over 85 per cent of its operating funds.

The OHA set up HOOPP in 1960 to provide an industry-wide defined benefit pension plan which would allow a plan participant to move from one hospital employer to another with no loss of pension benefits. Plan administration and investment management are centralized. Each employee makes the same percentage contribution to the HOOPP Fund. The benefit package is uniform across the HOOPP system.

Figure 12.2 shows the number and type of participating employers, the number of active plan members by employer, and the major unions representing the employees.

Employers Participating in HOOPP and the Major Unions Representing Plan Members

Employers	Number	Active Plan Members	Major Unions
Hospitals	211	67,205	1. Service Employees International Union (SEIU)
District Health Councils	25	70	2. Ontario Nurses Association (ONA)
Laundry Facilities	8	238	3. Canadian Union of Public Employees (CUPE)
Homes for the Aged	8	277	4. Ontario Public Service Employees Union (OPSEU)
Other health-related employers	49	2688	
TOTAL	**301**	**70,478**	

FIGURE 12.2

Sixty per cent of the employees of the hospitals and other health-related institutions which participate in HOOPP belong to a union. Collective bargaining, while permissible, is impractical because of the number of employers and unions and

[1] OHA Brief, page 1.

because the plan provides a common pension benefit for all employees. There are 700 separate labour agreements in the hospital field.

The chapter is divided into three sections:

I. **The pension deal**

II. **Views of plan members and the OHA**

III. **Changes needed to the pension deal**

SECTION I

The Pension Deal

Roles of Participants

Unlike other major public sector pension deals, the HOOPP pension deal is not established by statute but is set up under the Pension Benefits Act.

Figure 12.3 summarizes the roles and responsibilities of each party to the HOOPP pension deal.

HOOPP Roles and Responsibilities

Sponsor	Employer	Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
OHA	Hospitals and other health-related institutions	Hospitals and other health-related institutions	National Trust	National Trust	OHA Board	OHA

FIGURE 12.3

While the OHA is the plan sponsor, the individual hospitals and other health-related institutions are responsible for ensuring that contributions plus investment returns are sufficient to pay the benefits promised. National Trust Company is the trustee and custodian. The investment policy maker is the OHA board of directors. Investment management is assigned to an OHA staff group.

Figure 12.4 illustrates the relationship among the various parties involved in HOOPP.

HOOPP Fund Structure and Decision-Making Relationships

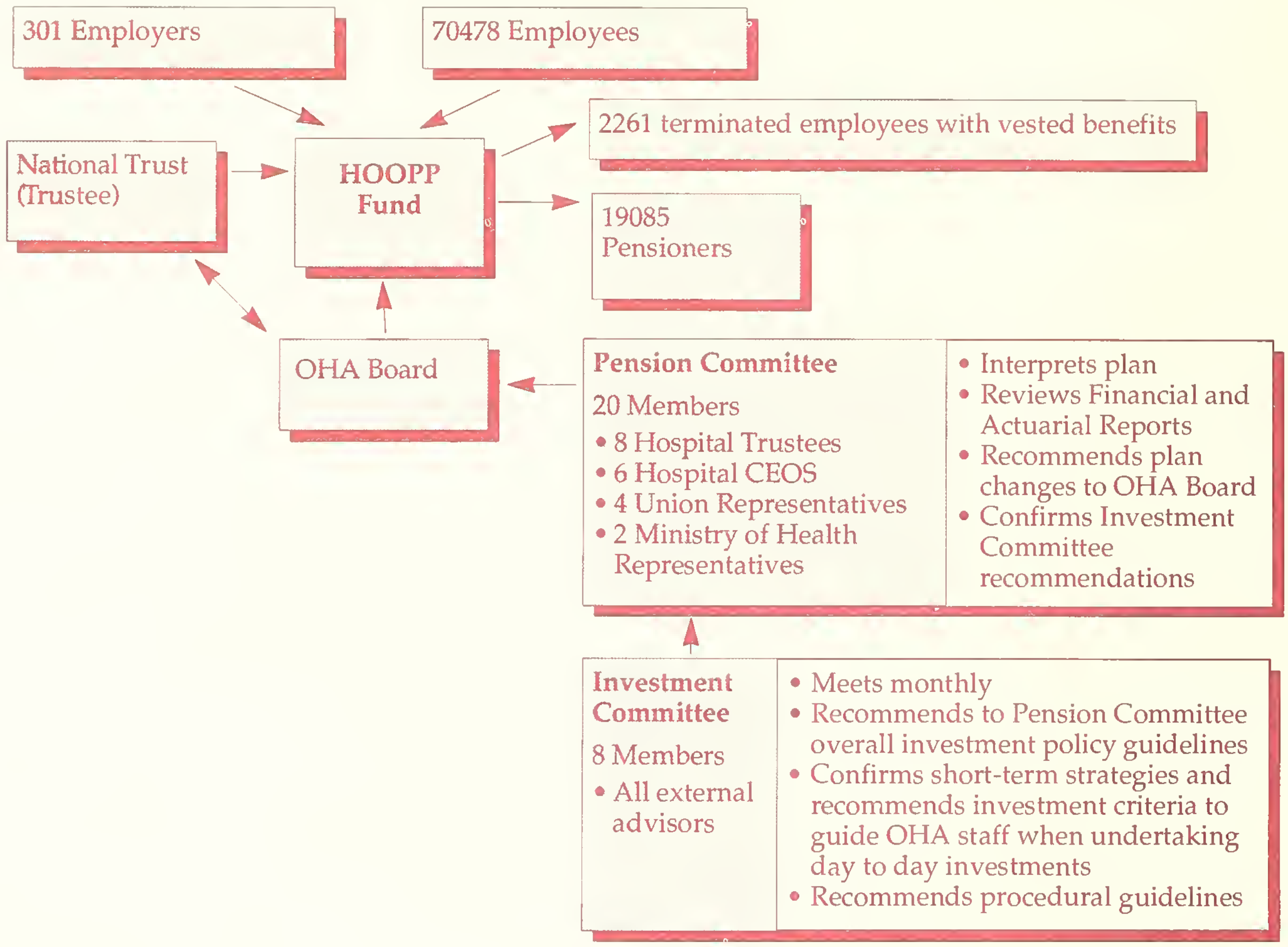


FIGURE 12.4

The 46-member OHA Board of Directors has overall responsibility for the HOOPP plan and fund. The directors of the OHA, both hospital trustees and administrative personnel, are selected on a regional basis. The President of the OHA is also a board member. Members of the OHA Board who are hospital administrators, plus the President and staff of the OHA, are HOOPP plan members.

The OHA Board has established a pension committee to administer HOOPP. Specifically, the committee interprets the plan, reviews financial and actuarial reports and recommends changes to the plan. The OHA Board has final responsibility. The Pension Committee has 20 members – four union representatives, eight hospital trustees, six hospital chief executive officers and two Ministry of Health representatives.

An eight-member Investment Committee, which advises the President of the OHA who reports to the Pension Committee, meets monthly and recommends overall investment policy guidelines, confirms short-term investment strategies and recommends investment criteria.

The Investment Committee is appointed by the Chairman of the OHA Board and is comprised of investment specialists. The Committee recommends procedural guidelines to the Pension Committee. There are no plan member representatives on the Investment Committee.

Investment management is the responsibility of the OHA Investment Division staff, within constraints established by the Pension Benefits Act and regulations and by the the OHA Board.

In 1973, the OHA hired professional internal investment managers and, in 1978, took direct responsibility for the management of the whole fund. Three external investment managers manage HOOPP's relatively small non-North American investments.

Investment Policy

The primary purpose of the HOOPP Fund is to meet the obligations of the HOOPP plan. The HOOPP Fund investment objective is to maximize the long term rate of return on assets, given existing legal and investment policy constraints.

HOOPP invests in a wide variety of market investments, including government and corporate bonds, equities, mortgages, real estate and short-term securities.

Figure 12.5 summarizes the HOOPP Fund's investment portfolio in 1986.

Percentage of Assets by Category in 1986

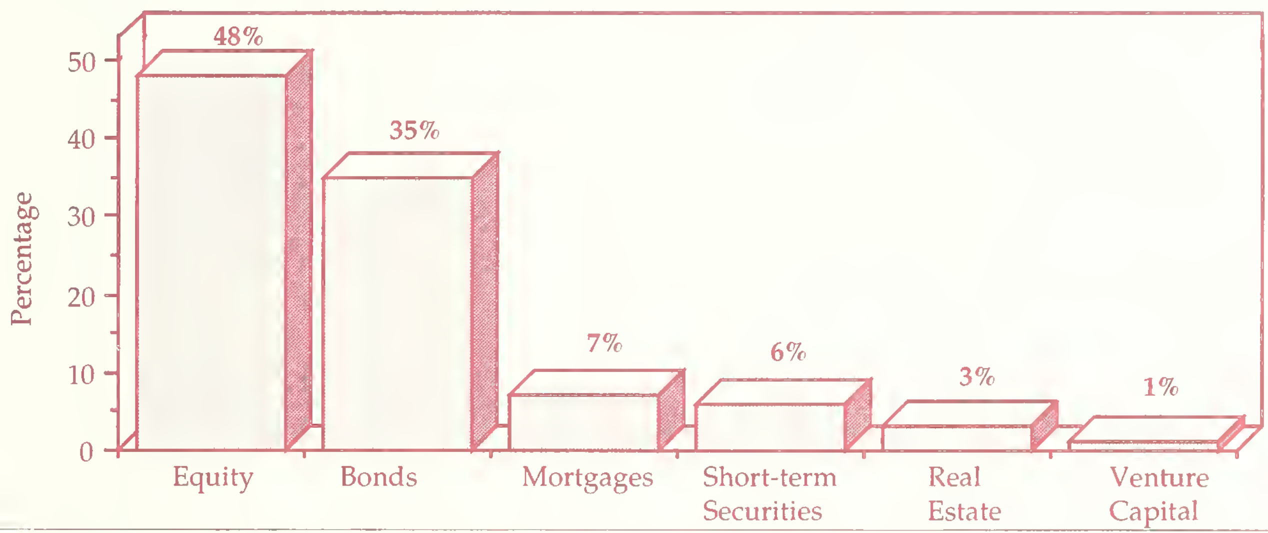


FIGURE 12.5

Growth of HOOPP

The growth of HOOPP is illustrated in Figure 12.6.

Growth of the HOOPP Fund ~ 1965 - 1986

Year	Assets * ($ Million)	Active Plan Members	Annual Contributions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1965	46.2	23,942	10.6	1,426	0.6
1970	134.0	48,398	22.0	4,076	2.1
1980	1,206.0	74,729	155.9	12,784	19.1
1986	3,278.0	77,614	159.5	19,563	55.5

* Book value.

FIGURE 12.6

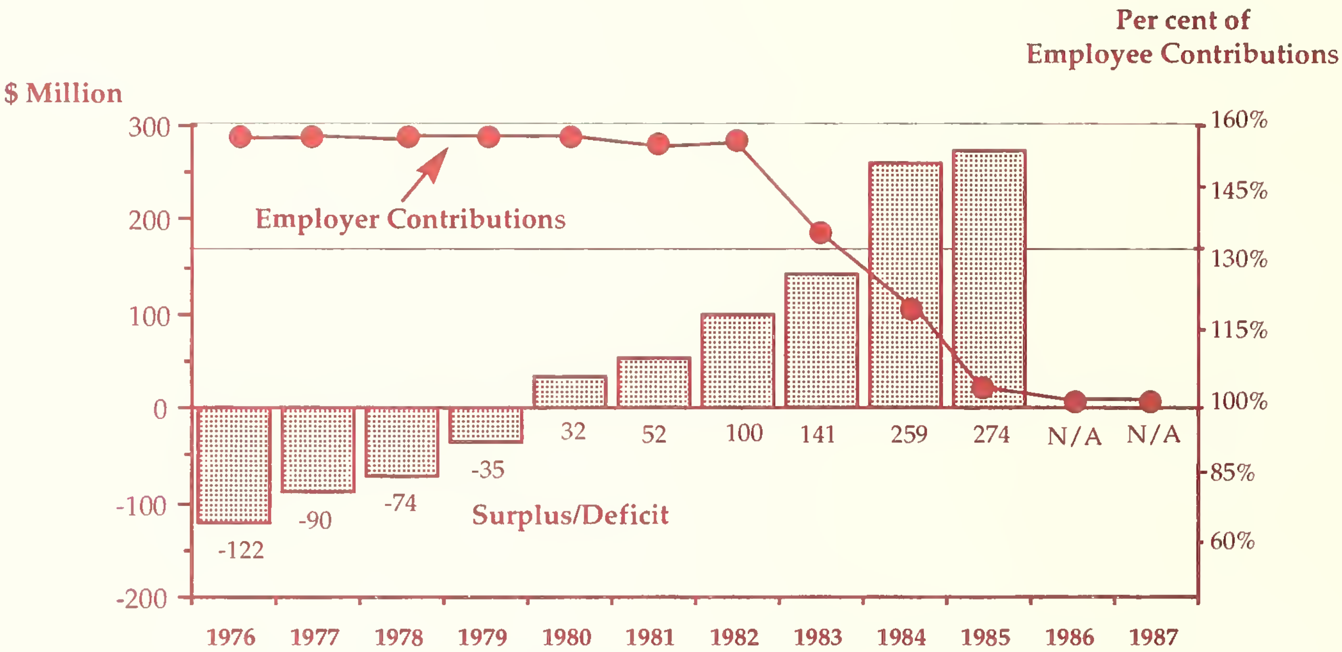
Since 1965, HOOPP fund assets have increased by 844 times, the number of active plan members has increased by over 3 times, the number of pensioners has increased by almost 14 times, and the annual pension benefits paid have increased by over 92 times.

Record of Surpluses and Deficits and Employer Contribution Rates

Figure 12.7 illustrates the record of surpluses and deficits in the HOOPP Fund since 1976, and the employer contributions as a percentage of employee contributions in each year over the period 1976-1987.

Comparison of the HOOPP Surplus (Deficit) and the Employer Contributions as a Percentage of Employee Contributions

1976-1986



Source: Public Sector Pensions Advisory Board Staff and OHA

FIGURE 12.7

The HOOPP Fund had a deficit from 1976 to 1979. The deficit amounted to $122 million in 1976, declining to $35 million in 1979, after which there have been annual surpluses. It had a surplus of $274 million as of the latest actuarial valuation of December 31, 1985.

From 1976 through 1982, employer contributions were 158 per cent of employee contributions, dropping to 100 per cent in 1986 and 1987.

The Formal Deal vs Current Practice

Figure 12.8 compares the formal pension deal for HOOPP with current practice and identifies areas of difference (represented by the shaded areas).

The **formal pension deal** can be summarized as follows:

- The pension deal is a defined benefit related deal.
- The pension benefit is determined by a formula based on a combination of years of service and the average salary earned in the best five years of service.

HOOPP ~ Formal Pension Deal

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit*	2% per year of service based on best 5 years	Employee: fixed	Ongoing surplus* not stated	Market investments	Plan Administration: Plan Sponsor	OHA (Collective bargaining not prohibited)
		Employer: variable	Deficit: employer		Investment Management: Plan Sponsor	

* Employer contribution rates are variable depending on the funding status of the HOOPP Fund. Termination surplus belongs to employees.

HOOPP ~ Current Practice

Kind of Deal	Benefits Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit + shared surplus	2% per year of service based on best 5 years + ad hoc inflation	Employee: fixed	Ongoing surplus shared*	Market investments	Plan administration: partially shared with plan members	OHA (collective bargaining not prohibited)
		Employer: variable	Deficit: employer		Investment Management: partially shared with plan members	

* Employer contribution rates are variable depending on the funding status of the HOOPP Fund. Termination surplus belongs to employees.

FIGURE 12.8

- The employees make fixed contributions of 6 per cent of salary above the CPP maximum earnings level. The employer makes variable contributions based on what is needed to keep the fund actuarially sound.
- The employer is responsible for any deficit.
- A surplus on termination belongs to plan members. Who owns an ongoing surplus is not stated, although employer contribution rates are variable depending on the funding status of the HOOPP Fund.
- Investment policy, investment management and plan administration are the responsibility of the OHA Board.
- Benefit changes must be approved by the OHA Board.
- Collective bargaining is permissible in the hospital sector but is difficult (and is not used) for pension benefits.

Current practice differs from the formal pension deal in three ways:

- First, the ongoing surplus has been allocated in part to improve benefits and is therefore shared with plan members.
- Second, pensions paid to HOOPP beneficiaries have been partially protected from inflation by way of annual ad hoc increases since 1979. On average, these increases have exceeded 50 per cent of the annual inflation rate.

- Third, union representatives have been added to the Pension Committee and share in most aspects of plan administration and (to a lesser extent) investment decisionmaking.

Problems with the Formal Pension Deal

The formal pension deal provides that any surplus remaining in the unlikely event of a plan termination would belong to plan members, notwithstanding that they may have already received the pension benefit promised to them. This provision would provide a windfall to plan members at the time of termination.

SECTION II

Views of Plan Members and the OHA

This section reviews comments received from the OFL and the OHA, and the Task Force's response.

For the most part, the comments received from the OFL and affiliated public sector unions are not directed specifically to the HOOPP Fund. As a result, we have exercised judgement in relating them to the HOOPP Fund.

The comments fall into the following categories:

- employer guarantee of defined benefit
- employer contribution rates
- inflation indexation
- ownership of a surplus (deficit)
- pension fund structure and control
- centralization of pension funds
- investment policy
- process for changing the pension deal

Employer Guarantee of Defined Benefit

The current HOOPP pension deal is a defined benefit related deal and includes the employer's guarantee of the pension benefit.

The OHA advises that its members are prepared to continue to guarantee the pension promise provided their contribution rate is variable – that is, the employer contributes whatever it takes to keep the pension fund actuarially sound.

The OFL favours a defined benefit plan (as opposed to a defined contribution pension plan) because it believes the employer has a higher tolerance for risk than do plan members. In the OFL's view, the employer should guarantee the pension promise and pay for any deficit in the pension fund but not have access to any pension fund surplus, no matter how derived.

The OFL states that a pension deal of this kind is "just good public policy." Indeed, even if collective bargaining for pensions took place in the hospital sector and

unions were not able to negotiate this kind of deal, the OFL says that legislative remedies would be the logical next step.[2]

We do not endorse the OFL's position. Among other matters, the OFL position ignores two essential points:

- whether an individual employee does or does not have a higher tolerance for risk than the individual taxpayer has not been demonstrated.
- even if it is true that taxpayers, either individually or collectively, have a higher tolerance for risk, it does not follow that taxpayers should be asked to bear a disproportionate amount of risk.

Public policy may ultimately support the OFL's point of view. Before it does, we would point out the very high cost to the taxpayer if such a policy is applied to public sector pension plans.

Employer Contribution Rates

HOOPP employer contribution rates have ranged from 150 per cent of employee contributions in 1960, to 170 per cent in 1966, to 100 per cent in 1986 and 1987.

The OFL states that "public sector unions believe that employer contribution rates should never be allowed to fall below the prior year's rate of contribution (and) in no event should employer contributions ever be allowed to fall below employee contributions when the plan is contributory."[3]

The OHA believes that HOOPP employers' contributions are variable and should be set at whatever level is necessary to ensure that the plan is funded in accordance with the funding requirements of the Pension Benefits Act, 1987.

During the 1960's and 1970's employer contributions to the HOOPP Fund were significantly higher than employee contributions, due in large part to the need to fund unfunded liabilities and benefit increases. See Figure 12.7.

Because of recent surpluses, employer contributions have been reduced to the point where they now match employee contributions. The HOOPP plan actuary recommended that contributing employers take a contribution holiday in 1987. After discussions with the Ministry of Health and the Pension Commission of Ontario, the OHA decided not to reduce employer contributions.

As noted in Chapter 11, the legality of Ontario Hydro taking a contribution holiday in the context of the Hydro plan is currently before the courts. Like the Hydro plan, the HOOPP plan contemplates that employer contributions could be variable.

It should be noted that where an employer has the right under a pension deal to vary his contribution rate, the Pension Benefits Act, 1987 may impose constraints on that right. Section 40 of that Act in effect requires that employer contributions plus any investment earnings thereon must add up to at least 50 per cent of the value of a plan member's pension in respect of years after 1986. However, this is not a requirement that the employer's contributions must at all times match the

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[2] Based on a meeting with the OFL August 21, 1987.

[3] OFL Brief, page 21.

employees' contributions. The calculation required by Section 40 is based on the entire period of a plan member's employment.

Inflation Indexation

The OFL argues that, in conditions of inflation, the pension promise is essentially broken if pensions are not indexed. The OFL also notes that "surpluses of most pension plans arise precisely because the real value of benefits (to retirees) are eroded."[4]

The OHA points to a record of providing ad hoc inflation adjustments to pensions. However, the timing and amount of any such adjustment is at the discretion of the OHA Board. No promise has been made to plan members that they will be made in the future.

We note that mandatory inflation indexing is to be implemented under the Pension Benefits Act, 1987. The Task Force on Inflation Protection for Employment Pension Plans is addressing the means by which it can be implemented.

Ownership of a Surplus (Deficit)

The OFL argues that a surplus in a pension fund should be used to improve the benefits for plan members, to provide inflation protection for pensioners and their beneficiaries and to extend coverage to other workers.

The OHA's position is that contributing employers are entitled to reduce their contributions and even to take a contribution holiday if a surplus arises, just as they are obliged to make additional contributions if a deficit arises.

As indicated above, the issue of a contribution holiday by Ontario Hydro is before the courts.

In Chapter 3, we noted that a surplus can have two parts:

- an investment risk surplus, and
- an actuarial surplus[5]

This distinction is useful in thinking through which party or parties may be entitled to which parts of a surplus, although the assumptions underlying an existing actuarial surplus may not have been structured so as to assist in allocating it.

There is a plausible argument, in the context of a contributory defined benefit pension deal, that plan members may be entitled to a share of an actuarial surplus. This argument is based on the view that, if employee contribution rates are determined, explicitly or implicitly, on the basis of conservative (as opposed to best estimate) actuarial assumptions, leading to an actuarial surplus, employees are entitled to that part of the actuarial surplus that results from their over-contributions.

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[4] OFL Brief, page 21.

[5] An investment risk surplus (or deficit) results from adopting an investment policy with a level of risk above that related to an investment policy that is essentially risk free.

An actuarial surplus is the remainder of any surplus and results from actual experience being better than the actuary assumed.

While the Task Force has no way of verifying the linkage between the HOOPP Fund's actuarial assumptions and employee contribution rates, we believe such a linkage should not be ruled out. Nor should the employees' right to share in an actuarial surplus to the extent of their over-contributions be ruled out.

Further, the taxpayer also is entitled to that part of the actuarial surplus resulting from employer over-contributions.

The taxpayer alone should be entitled to any investment risk surplus if it is clear that he bears the burden of any deficit. Since plan members do not appear to share directly in the investment risk, in our view they are not entitled to share in any investment risk surplus.

We note that to the extent that a surplus is not distributed, it provides a contingency reserve or cushion against future actuarial or investment risk deficits. In our view, it would be prudent to leave at least part of an actuarial surplus or investment risk surplus in the HOOPP Fund as a contingency reserve, since the $274 million surplus as of December 31, 1985, represented under 8 per cent of the assets of the Fund as of December 31, 1986.

This leaves unanswered the question: who should be responsible for an actuarial deficit if actuarial assumptions are wrong?

Some union representatives have argued that history shows there is a much greater chance of there being an actuarial surplus than a deficit because actuaries use very conservative assumptions. This is another way of arguing that the employee contribution rate is usually set too high.

While this argument may be correct, history also shows that employers have had to make considerable extra payments to cover deficits which arose, at least in part, because actuarial assumptions were wrong (i.e. experience deficiencies). See Figure 12.7.

The responsibility for such deficits in a defined benefit related deal rests with the employer and, in our view, should continue to do so.

Pension Fund Structure and Control

The OFL states that, "the minimum position acceptable . . . is joint trusteeship in any plan where the unions so desire."[6]

Given the nature of the current HOOPP pension deal, we do not endorse joint trusteeship. We do endorse minority representation by plan members for defined benefit related deals, where practical.

The decision-making body for HOOPP is the OHA Board which has a wide range of responsibilities in addition to the HOOPP plan and fund. It is not clear, in this structure, how plan member representation in investment decision-making for the HOOPP Fund could be provided, other than through the Pension and Investment Committees.

[6] OFL Brief, page 25.

Centralization of Pension Funds

Both the OFL and the OHA are opposed to the further centralization of the investment management of Ontario public sector pension funds. We support this position for reasons set out in Chapter 4.

Investment Policy

The OFL makes two proposals relating to investment policy in general:

- First, it argues that ethical and social objectives should be pursued, without impairing either the security or the earnings of pension funds, provided the objectives sought are those of plan members. It urges that the fiduciary responsibilities of pension fund trustees should be defined in legislation so as to provide for this.[7] We deal with this topic in Chapter 5.

- Second, it proposes that the Government establish new investment vehicles, with competitive rates and government guarantees, to enable pension funds to make social investments such as loans for non-profit housing co-operatives or new manufacturing in Northern Ontario.[8]

  As noted in Chapter 5, we agree that where the Government wants to attract pension fund investments in areas of social policy priority, it should provide incentives or guarantees to ensure such investments are competitive. Pension fund investments should be voluntary, not directed by the Government.

The OHA's position is that pension fund governors should seek to maximize returns on investments while exercising their fiduciary responsibility to manage investments prudently. The OHA opposes the Government direction of pension fund investments. We agree with the OHA's position.

Process for Changing the Pension Deal

The OFL believes that the HOOPP pension deal should be the subject of collective bargaining along with other parts of total compensation. Salaries are now bargained collectively for most hospital employees.

The OFL believes that the Government should remove structural barriers in the HOOPP system so that province-wide or union-wide bargaining, including bargaining for pension benefits, can take place.

The Task Force feels that a clear link between pension benefit decisions and salary decisions is desirable, whether through collective bargaining or some other means. We recognize that this is difficult for a multi-employer plan such as HOOPP, but feel that the effort should be made.

See Chapter 3, Section IX, for our general comments on the process for changing the pension deal.

Summary of Views

Figure 12.9 summarizes the comments of the OFL and the OHA and sets out the Task Force's response.

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[7] OFL Brief, pp. 26-29.

[8] OFL Brief, pp. 31-33.

Summary of Comments by the OFL and the OHA and Task Force's Response

OFL Comments	Task Force Response	Comments
Employer should guarantee pension benefit	Agree	Consistent with pension deal
Employers' contributions should not fall below employee's contributions	Do not agree	Variable employer contribution rates are consistent with defined benefit pension deal and HOOPP pension deal
Pensions should be indexed to inflation	To be mandatory under Pension Benefits Act, 1987	HOOPP has provided ad hoc partial inflation adjustments
HOOPP Fund surplus belongs to plan members	Do not agree	Not consistent with HOOPP's variable employer contribution rate. HOOPP pension deal currently provides that a surplus on plan termination must be allocated to the then plan members.
Employees should have joint control of HOOPP Fund	Do not agree (but minority representation of plan members should be provided)	Plan members do not share HOOPP Fund deficit
HOOPP Fund should remain separate from other public sector pension funds	Agree	Fund structure is not an employee decision. Continued separation is desirable for other reasons
Plan members' social objectives should be pursued when consistent with the security and earnings of the Fund	Do not agree	It is a decision for the pension fund governors
Government should not direct HOOPP Fund investments	Agree	Better for Government to provide incentives to attract investments
Salaries and pensions should be negotiated within a total compensation context	Agree	Acknowledge practical difficulty, but needs to be done

OHA Comments	Task Force Response	Comments
Variable employer and fixed employee contributions should continue	Agree	Consistent with defined benefit kind of pension deal and within HOOPP pension deal
Employers are entitled to reduce their contributions if a surplus arises	Agree	Consistent with HOOPP pension deal
HOOPP Fund should remain separate from other public sector pension funds	Agree	Continued separation desirable
Government should not direct HOOPP Fund investments	Agree	Better for Government to provide incentives to attract investments

FIGURE 12.9

Figure 12.10 summarizes our understanding of what the OFL would like in the HOOPP pension deal, and what types of deal this assumes.

OFL and CUPE Comments by Type of Pension Deal

Defined Benefit Related Deal	Combined Deal	Asset Related Deal	Independent
Government should guarantee benefit	Employer contributions should at least match employee contributions	Surplus belongs to plan members	Pensions should be indexed to inflation
—	Employees should have at least joint control of HOOPP Fund	—	Link salary and pension benefits within a total compensation context
—	—	—	HOOPP Fund should remain separate from other public sector pension funds

FIGURE 12.10

The OFL appears to want the best features of both asset related and defined benefit related pension deals, and none of the risk of either. The fact that it wants the employers to match or exceed employer contributions suggests that it also wants elements of a combined deal.

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the HOOPP pension deal to address problems we have identified and to respond to some of the comments of the OFL and the OHA.

Variable Employer Contribution Rates/Ownership of an Ongoing Surplus

The plan documentation is silent on who owns an ongoing surplus. However, it does provide for a variable employer contribution rate determined in relation to the actuarial soundness of the HOOPP Fund. The OHA believes that the employers are entitled to reduce their contributions below employee contributions or even to take a contribution holiday if a surplus exists and the circumstances are otherwise appropriate.

The question whether or not this is a correct interpretation of the HOOPP plan document may be answered in the final disposition of the Ontario Hydro case currently before the courts and referred to in Chapter 11. Assuming that it is a correct interpretation of the HOOPP plan, the Task Force believes that the OHA, in

light of the current surplus in the HOOPP Fund, should further reduce employer contributions and, if appropriate, should permit employers to take a contribution holiday, thereby benefiting the taxpayer.

As indicated above, the OHA decided not to reduce employers' contributions to the HOOPP Fund in 1987 as recommended by the HOOPP plan actuary. The Task Force believes that the OHA should be free to reduce employer contributions when it is appropriate to do so.

If there is no reduction of the employers' contributions in accordance with the HOOPP plan, then tax dollars will be diverted unnecessarily into the HOOPP Fund. This is likely to result in pension benefits being improved just because there is a surplus, not because of a real requirement for improvements in total compensation.

The potential savings to the taxpayer are substantial. For example, between 1982 and 1985, when employer contributions were reduced in stages from 158 per cent to 102 per cent of employee contributions, employers' total costs were reduced by $93.3 million.[9]

Recommendation 12.1

The Ministry of Health and the Ontario Hospital Association should determine whether any savings arising from reduced employer contributions to the HOOPP pension fund should remain in the health care system for non-pension uses or should benefit the taxpayer through a reduction in grants to hospitals.

Ownership of a Surplus on Plan Termination

The plan documentation provides that any surplus remaining in the HOOPP Fund on plan termination, after all pensions promised pursuant to the HOOPP pension deal have been paid, belong to the plan members.

The Task Force does not believe this is fair to the taxpayer.

As indicated in Chapter 3, employer contributions in a defined benefit related pension deal are based on actuarial assumptions about the future and these assumptions are likely to be wrong. Accordingly, it is difficult, if not impossible, to determine whether contributions made in accordance with actuarial assumptions will result in the plan having a surplus or deficit. This is particularly so in a plan wind-up situation where the conservative, long-term assumptions used by the actuary encounter the reality of the time.

The result could be a considerable windfall to those who are plan members at the time, to the detriment of the taxpayer who provided at least 50 per cent of the funding.

While it is unlikely that the HOOPP pension deal will be terminated, it is possible that one or more of the contributing employers could cease operations. Accordingly,

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[9] Ontario Hospital Association brief, p. 25.

the Task Force believes that this provision should be removed from the HOOPP pension deal.

Recommendation 12.2

The Ontario Hospital Association should amend the HOOPP plan to provide that any surplus on plan termination is refunded to employers.

The Task Force emphasizes that this amendment would not reduce the benefits which plan members have been promised under the HOOPP plan.

In the event that a termination surplus is refunded to an employer, it would be up to the Ministry of Health to determine whether this should result in a comparable reduction in that employer's operating grant.

Pension Fund Structure and Control

In the present structure, the OHA is both the sponsor of HOOPP and the HOOPP Fund governors. The OHA Board is also responsible for a broad range of functions in addition to the pension plan.

The OHA has provided for plan member representation in pension plan decision-making by appointing four union officials to the Pension Committee which administers the plan. However, the Pension Committee has only an advisory role with respect to the HOOPP Fund. It is clear, though, that the recommendations of the Pension Committee are invariably adopted by the OHA Board.

The Investment Committee, which reports to the President of the OHA (who is also a member of the Pension Committee) and to the OHA Board, has no plan member representation. Since the HOOPP Fund is required to be managed in the interests of plan members, it is desirable to include on that committee a plan member or representative who is not part of management.

Recommendation 12.3

The Ontario Hospital Association appoint at least one non-management plan member or representative to the HOOPP Investment Committee.

Conclusion

This chapter reviewed the HOOPP pension deal and the comments of the OFL and OHA. It recommended that the Ministry of Health and the OHA should determine whether hospitals or taxpayers should benefit from savings from lower employer contribution rates. It also recommended changes to the pension deal to provide that any surplus on plan termination should be refunded to the employers who contributed to the plan. In addition, there should be minority plan member representation on the HOOPP Investment Committee.

CHAPTER 13

WORKERS' COMPENSATION BOARD SUPERANNUATION FUND (WCB)

SYNOPSIS

Current practice is reasonably well aligned with the formal pension deal. The WCB should review its pension fund structure and decision making. A clearer separation in decision-making is needed between the WCB accident and pension funds. Plan member involvement in investment decision making is desirable.

Introduction

This chapter reviews the current pension deal with WCB employees. It also reviews comments expressed by representatives of plan members and the Task Force's response.

Figure 13.1 provides an overview of the WCB Fund.

Overview of the WCB Fund as at December 31, 1986

Fund	Sector	Assets* ($ Million)	Rank by Assets	Employers	Active Plan Members	Benefi-ciaries	1986 Cash Flow ($ Million)	Surplus** (Deficit) ($ Million)
WCB	Govern-ment	254	16	9	4,090	776	23	35

* Market value
** December 31, 1985.

FIGURE 13.1

The WCB Fund is Ontario's sixteenth largest public sector pension fund, with assets of $254 million. There are 9 employers, over 4,000 plan members, and almost 800 beneficiaries. Its 1986 cash flow was $23 million. The WCB Fund had an actuarial surplus of $35 million as of December 31, 1985.

The WCB plan includes the employees of the WCB and 8 industry safety associations.

Participation in the WCB plan is mandatory for all full-time employees. Collective bargaining on pensions is prohibited. The employer tracks changes in pension benefits made in the public sector and initiates any WCB plan changes considered

necessary. Discussion with employees on pension benefit changes takes place through the Joint Insurance Benefits Review Committee. Cabinet approval of any benefit or contribution rate changes is necessary. Obtaining this approval can take up to 6 months.

Figure 13.2 shows the number and type of employers, the number of employees by employer, and indicates how many are union members and how many are not.

Employers Participating in the WCB Pension Deal and the Union Representing Employees
July 8, 1987

Employers	Active Plan Members		Union
	Non-Union	Union	
WCB	1797	1953	Canadian Union of Public Employees (CUPE) Local 1750
Safety Associations			
• Construction	115	—	
• Electrical	25	—	
• Industrial	196	—	
• Forest products	21	—	No union members in safety associations
• Mines	27	—	
• Pulp and paper	9	—	
• Farm	14	—	
• Transportation	22	—	
TOTAL	**2226**	**1953**	

FIGURE 13.2

None of the employees of the eight safety associations is represented by a union. About 53 per cent of WCB employees are represented by CUPE. None of the WCB's nine part-time board members are plan members; the Chairman and President are plan members.

The chapter is divided into three sections:

I. **The pension deal**

II. **Views of plan members and the WCB**

III. **Changes needed to the pension deal**

SECTION I

The Pension Deal

Roles of Participants

The WCB pension plan is authorized by the Workers' Compensation Act. It also is governed by the Pension Benefits Act.

Figure 13.3 summarizes the roles and responsibilities of the various parties to the WCB pension deal.

WCB Roles and Responsibilities

Sponsor	Employer	Employer Contributor	Custodian	Trustee	Investment Policy Maker	Investment Manager
WCB	WCB and eight Safety Associations	WCB	None Designated	None Designated	WCB Board	WCB Staff

FIGURE 13.3

The WCB is the plan sponsor. There is no designated custodian or trustee but the WCB considers that it acts in those roles.

Relationship of Participants

Figure 13.4 illustrates the relationship among the various parties involved in the WCB pension deal.

WCB Structure and Decision-Making Relationships
December 31, 1986

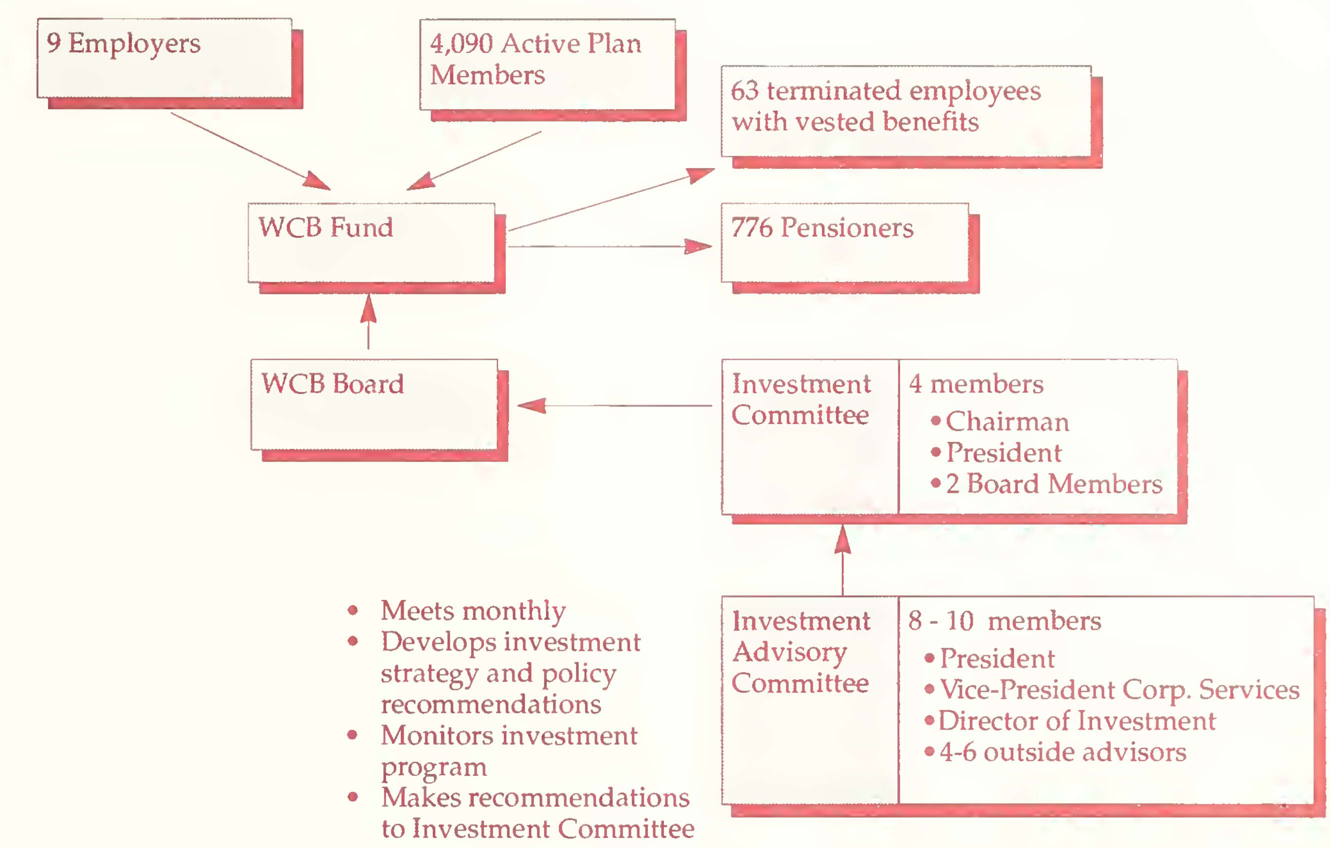


FIGURE 13.4

The WCB Board of Directors has final approval of all pension plan decisions except for benefit policies. That responsibility rests with the Lieutenant Governor in

Council. The WCB Board is composed of 11 members – the Chairman, the President, four labour representatives, four employer representatives and a representative of the public.

Reporting to the Board is an Investment Committee which is responsible for the investment of the WCB accident fund[1] and the WCB pension fund. The Chairman, the President, and two Board members make up the Investment Committee. This Committee receives and deals with the recommendations of the Investment Advisory Committee.

The WCB Board has recently established an Investment Advisory Committee, comprised of the President, Vice-President of Corporate Services, Director of Investments and four to six outside advisors. It is responsible for developing investment policy and strategy, for monitoring the investment program and for making recommendations to the Investment Committee.

All investments are internally managed by a staff of four with the advice of an external equity advisor.

There is no employee involvement in any part of the pension plan decision-making process. However, union representatives are consulted regarding proposed benefit changes.

Investment Policy

The primary purpose of the WCB Fund is to hold assets to meet the obligations of the WCB plan. The investment objective of the WCB Fund is to maximize the long-term rate of return on assets, given existing legal and investment policy constraints.

The WCB Fund is invested in market investments within the constraints established by the Pension Benefits Act. Investments are in government and corporate bonds, corporate shares, mortgages, real estate, and short-term securities.

Figure 13.5 summarizes the WCB Fund's investment portfolio in 1986.

Percentage of Assets by Category in 1986

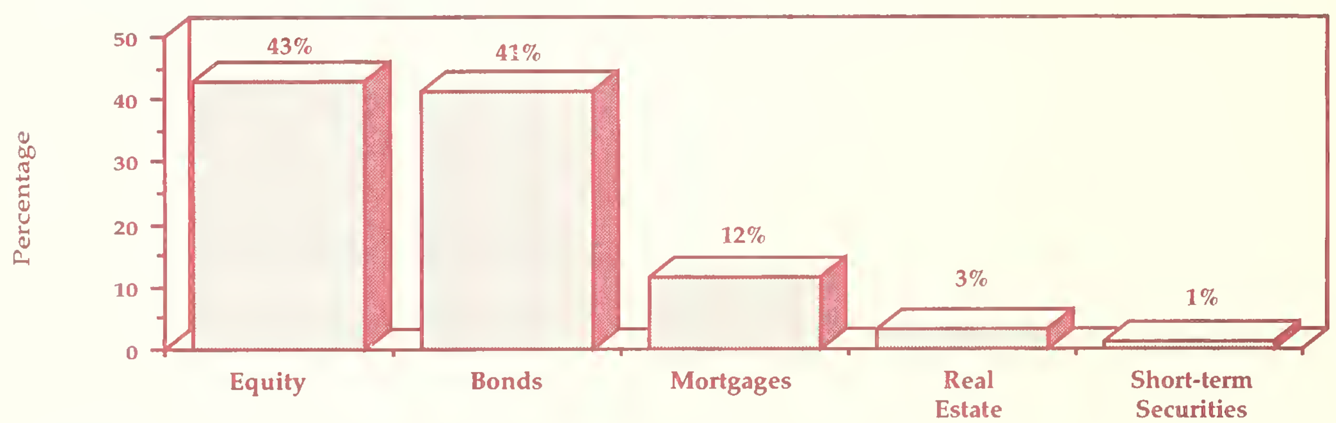


FIGURE 13.5

[1] The WCB accident fund is designed to provide compensation to Ontario workers who are injured on the job or who contract an occupational disease. Compensation includes payment of health care expenses, payment for loss of wages that may result from the injury or disease, a wide range of vocational and medical rehabilitation services, permanent disability pensions, and death benefits to surviving dependents. Employers are required to make contributions to the WCB accident fund.

Growth of the Fund

The growth of the WCB Fund is summarized in Figure 13.6.

Growth of the WCB Fund: 1965–1986

Year	Assets[1] ($ Million)	Active Plan Members	Annual Contri-butions ($ Million)	Beneficiaries	Annual Pension Benefits Paid ($ Million)
1965	16.7 [1]	1,199	N/A	86	N/A
1970	48.7 [1]	1,968	5.6	301	1.1
1980	95.0 [2]	2,821	6.2	464	2.5
1986	254.0 [2]	4,090	10.7	776	6.2

[1] Book value
[2] Market value

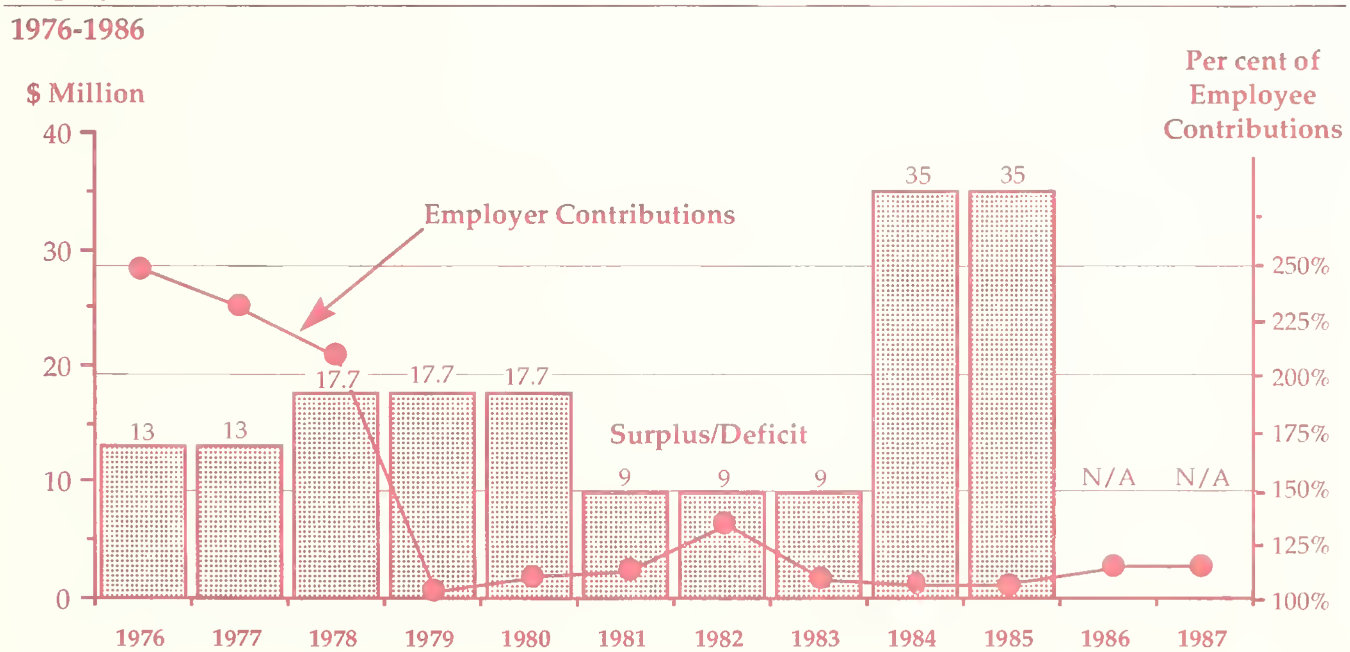
FIGURE 13.6

Since 1965, WCB Fund assets have increased by about 15 times, the number of active plan members has more than tripled, the number of beneficiaries has increased by nine times, and the annual pension benefits paid has increased by over six times.

Record of Surpluses and Deficits and Employer Contribution Rates

Figure 13.7 illustrates the record of surpluses and deficits in the WCB Fund since 1976, and the employer contributions as a percentage of employee contributions each year over the same period.

Comparison of the WCB Surplus (Deficit) and the Employer Contributions as a Percentage of Employee Contributions



Source: Public Sector Pensions Advisory Board Staff and WCB Staff

FIGURE 13.7

From 1976 to 1985, the WCB Fund was in a surplus position. During this period, the WCB made contributions above the level of employee contributions in all years, peaking at 235 per cent of employee contributions in 1976 and 1977 and dropping to a low of 106 per cent in 1985. In 1986 and 1987, the employer contribution rate increased to 113 per cent.

Formal Pension Deal vs Current Practice

Figure 13.8 compares the formal pension deal for WCB and safety association employees with current practice and identifies areas of difference (represented by the shaded areas).

WCB ~ Formal Pension Deal

Kind of Deal	Benefit Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit	2% per year of service based on best 5 years	Employee: fixed	Surplus: not stated	Market investments	Plan Administration: Employer	Legislation & Regulations & WCB initiatives
		Employer: variable	Deficit: employer		Investment Management: Employer	

WCB ~ Current Practice

Kind of Deal	Benefit Policy	Funding Policy	Ownership of Surplus (Deficit)	Investment Policy	Plan Administration and Investment Management	Process for Changing Deal
Defined Benefit & shared surplus	2% per year of service based on best 5 years & ad hoc inflation	Employee: fixed	Surplus: shared	Market investments	Plan Administration: Employer	Legislation & Regulations & WCB initiatives
		Employer: variable	Deficit: employer		Investment Management: Employer	

FIGURE 13.8

The **formal pension deal** can be summarized as follows:

- The pension deal is a defined benefit related deal.
- The pension benefit is determined by a formula based on a combination of years of service and the average salary earned in the best five years of service.
- The employees make fixed contributions to the fund of 6 per cent of salary above the CPP maximum earnings. The employers make variable contributions based on what is needed to keep the fund actuarially sound. Currently the employers' contributions are 113 per cent of employees' contributions.
- The employers are responsible for any deficit.

- Who owns a surplus is not stated.
- Benefit and contribution rate changes must be approved by the Lieutenant Governor in Council.
- Investment policy, investment management and plan administration are the responsibility of the WCB.
- Fundamental changes to the pension deal require amendments to the Workers' Compensation Act.
- Pension benefits are not negotiable.

Current practice differs from the formal pension deal in two ways:

- First, some of the surplus has been shared in the form of benefit improvements and ad hoc inflation protection.
- Second, the actuarial assumptions used to establish the employers' contributions assume that ad hoc inflation adjustments will be made to current pensions. This has led to increased employer contributions. The WCB was precluded from participating in the Superannuation Adjustment Fund in the late 1970's because the WCB was considered to be "independently" funded.

Problems With the Formal Pension Deal

There are two problems with the formal pension deal:

- First, the WCB is both the employer of most active plan members and the body responsible for the WCB Fund. This could give rise to a perceived conflict of interest for the WCB in carrying out the two roles.
- Second, the investment management responsibilities of the WCB Board, its Investment Committee and the Investment Advisory Committee in relation to the WCB accident fund and to the WCB pension fund are not separated.

SECTION II

Views of Plan Members and the WCB

This section reviews comments received from the OFL as well as the Task Force's response.

The OFL's submission was made on its own behalf and on behalf of other public sector unions, including CUPE. (CUPE Local 1750 represents about 47 per cent of plan members).

The comments received from the OFL for the most part were not directed specifically to the WCB Fund. As a result, we have exercised judgement in relating their comments to the WCB Fund.

No brief was received from the WCB, but the Task Force had discussions with WCB representatives.

The comments fall into the following categories:

- employer guarantee of defined benefit
- employer contribution rates
- inflation indexation
- ownership of a surplus (deficit)
- pension fund structure and control
- centralization of pension funds
- investment policy
- process for changing the pension deal

Employer Guarantee of Defined Benefit

The current WCB pension deal is a defined benefit related deal and includes the employers' guarantee of the pension benefit.

The OFL favours retention of a defined benefit plan (as opposed to a defined contribution pension plan) because it believes the employer has a higher tolerance for risk than do plan members. In the OFL's view, the employer should guarantee the pension promise and pay for any deficit in the pension fund but should not have access to any pension fund surplus, no matter how derived.

The OFL states that a pension deal of this kind is "just good public policy." Indeed, even if collective bargaining for pensions were to take place in the WCB and if the union was not able to negotiate this kind of deal, the OFL says that legislative remedies would be the next logical step.[2]

We do not endorse the OFL's position. Among other matters, the OFL's position ignores two essential points:

- whether an individual employee does or does not have a higher tolerance for risk than the individual taxpayer has not been demonstrated.
- even if it is true that taxpayers, either individually or collectively, have a higher tolerance for risk, it does not follow that taxpayers should be asked to bear a disproportionate amount of risk.

Public policy may ultimately support the OFL's point of view. Before it does, we would point out the very high cost to the taxpayer if such a policy is applied to public sector pension plans.

Employer Contribution Rates

The OFL states that "public sector unions believe that employer contribution rates should never be allowed to fall below the prior years' rate of contribution (and) in no event should employer contributions ever be allowed to fall below employee contributions when the plan is contributory."[3]

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[2] Based on a meeting with the OFL, August 21, 1987.

[3] OFL Brief, p. 21.

We do not support the OFL's position. The WCB pension deal specifically provides for variable employer contributions.

It should be noted that where an employer has the right under a pension deal to vary its contributions (as for the WCB), the Pension Benefits Act, 1987 may impose constraints on that right. Section 40 of the Act in effect requires that employer contributions plus any investment earning thereon must add up to at least 50 per cent of the value of a plan member's pension in respect of years after 1986. However, this is not a requirement that the employers' contributions must at all times match or exceed the employees' contributions. The calculation required by Section 40 is based on the entire period of a plan member's employment.

Inflation Indexation

The OFL argues that, in conditions of inflation, the pension promise is essentially broken if pensions are not indexed. The OFL also notes that "surpluses of most pension plans arise precisely because the real value of benefits (to retirees) are eroded."[4]

The WCB has provided periodic ad hoc inflation adjustments. However, such adjustments are at the discretion of the WCB, subject to approval by the Lieutenant Governor in Council. No promise has been made to plan members that they will be made in the future.

We note that mandatory inflation indexing is to be implemented under the Pension Benefits Act, 1987. The Task Force on Inflation Protection for Employment Pension Plans is addressing the means by which it can be implemented.

Ownership of a Surplus (Deficit)

The OFL argues that a surplus in a pension fund should be used to improve the benefits of active plan members to provide inflation protection for pensioners and their beneficiaries and to extend coverage to other workers.

We do not endorse this position.

In Chapter 3, we noted that a surplus can have two parts:

- an investment risk surplus, and
- an actuarial surplus[5]

This distinction is useful in thinking through which party or parties may be entitled to which parts of a surplus, although the assumptions underlying an existing actuarial surplus may not have been structured so as to assist in allocating it.

There is a plausible argument, in the context of a contributory defined benefit pension deal, that plan members may be entitled to a share of an actuarial surplus. This argument is based on the view that, if employee contribution rates are

[4] OFL Brief, p. 21.

[5] An investment risk surplus (or deficit) results from adopting an investment policy with a level of risk above that related to an investment policy that is essentially risk free.

An actuarial surplus is the remainder of any surplus and results from actual experience being better than the actuary assumed.

determined, implicitly or explicitly, on the basis of conservative (as opposed to best estimate) actuarial assumptions, leading to an actuarial surplus, employees are entitled to that part of the actuarial surplus that results from their over-contributions.

While the Task Force has no way of verifying the linkage between the WCB Fund's actuarial assumptions and employee contribution rates, we believe that such a linkage should not be ruled out and that plan members therefore may be entitled to a share of an actuarial surplus to the extent of their over-contributions.

Further, the taxpayer also is entitled to that part of the actuarial surplus resulting from employer over-contributions.

The taxpayer alone should be entitled to any investment risk surplus if it is clear that he bears the burden of any deficit. Since plan members do not appear to share directly in the investment risk, in our view they are not entitled to share in any investment risk surplus.

We note that to the extent that a surplus is not distributed, it provides a contingency reserve or cushion against future actuarial or investment risk deficits. In our view, it would be prudent to leave at least part of an actuarial surplus or investment risk surplus in the Fund as a contingency reserve, since the surplus of $35 million represented only about 14 per cent of the Fund as of December 31, 1986.

This leaves unanswered the question: who should be responsible for an actuarial deficit if actuarial assumptions are wrong?

Some union representatives have argued that history shows there is a much greater chance of there being an actuarial surplus than a deficit because actuaries use very conservative assumptions. This is another way of arguing that an employee's contribution rate is usually set too high.

While this argument may be correct, history also shows that employers have had to make considerable extra payments to cover deficits which arose, at least in part, because actuarial assumptions were wrong (i.e. experience deficiencies). Unlike the other major funds we examined, the WCB Fund did not have an experience deficiency during the period 1976-1985. See Figure 13.7.

The responsibility for deficits in a defined benefit related deal rests with the employer and, in our view, should continue to do so.

Pension Fund Structure and Control

The OFL states that, "the minimum position acceptable . . . is joint trusteeship in any plan where the unions so desire."[6] It is not clear how this position could be implemented in a situation such as the WCB where there is not a separate pension fund board. Even if there were a separate pension fund board, given the nature of the current pension deal, we would endorse only minority representation of plan members, not joint trusteeship.

Our view is that some plan member involvement in investment decision-making is appropriate and desirable in all cases. The way this is implemented will vary.

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[6] OFL Brief, p. 25.

Centralization of Pension Funds

The OFL is opposed to further centralization of the management of Ontario's public sector pension funds. We support this position for reasons set out in Chapter 4.

Investment Policy

The OFL makes two proposals relating to investment policy in general:

- First, it argues that ethical and social objectives can and should be pursued, without impairing either the security or the earnings of pension funds, provided the objectives sought are those of plan members. It urges that the fiduciary responsibilities of pension fund trustees should be defined in legislation so as to provide for this.[7] We deal with this topic in Chapter 5.

- Second, they propose that the Government establish new investment vehicles, with competitive interest rates and government guarantees, to enable pension funds to make social investments such as loans for non-profit housing co-operatives or new manufacturing in Northern Ontario.[8]

  As noted in Chapter 5, we agree that where the Government wants to attract pension fund investments in areas of social policy priority, it should provide incentives or guarantees to ensure such investments will be competitive. Pension fund investments should be voluntary, not directed by the Government.

Process for Changing the Pension Deal

The OFL believes that the WCB pension deal should be the subject of collective bargaining along with other parts of total compensation. Salaries are now bargained collectively for those WCB employees who are members of CUPE Local 1750.

The Task Force feels that a clear link between pension benefit decisions and salary decisions is desirable, whether through collective bargaining or some other means. See Chapter 3, Section IX, for our general comments on the process for changing the pension deal.

Summary of Views

Figure 13.9 summarizes the comments of the OFL/CUPE and sets out the Task Force's response.

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[7] OFL Brief, pp. 26-29.

[8] OFL Brief, pp. 31-33.

Summary of Comments by OFL/CUPE and Task Force's Response

OFL/CUPE comments	Task Force Response	Comments
Employer should guarantee pension benefit	Agree	Consistent with pension deal
Employer's contributions should not fall below employees' contributions	Do not agree	Variable employer contribution rates are consistent with defined benefit pension deal and WCB pension deal
Pensions should be indexed to inflation	To be mandatory under Pension Benefits Act, 1987	WCB has provided ad hoc partial inflation adjustments
WCB Fund surplus belongs to plan members	Do not agree	Plan members do not share WCB Fund deficit. They may be entitled to share an actuarial surplus
Employees should have joint control of WCB Fund	Do not agree (But minority representation of plan members should be provided)	Plan members do not share WCB Fund deficit
WCB Fund should remain separate from other public sector pension funds	Agree	Fund structure is not an employee decision. Continued separation is desirable for other reasons
Plan members' social objectives should be pursued when consistent with the security and earnings of the Fund	Do not agree	It's a decision for the pension fund's Governors
Government should not direct WCB Fund investments	Agree	Better for Government to provide incentives to attract investment
Salaries and pensions should be negotiated within a total compensation context	Agree	How to implement is beyond our terms of reference

FIGURE 13.9

Figure 13.10 summarizes our understanding of what the OFL/CUPE would like in the WCB pension deal, and what types of deal this assumes.

OFL/CUPE Comments by Type of Pension Deal

Defined Benefit Related Deal	Combined Deal	Asset Related Deal	Independent
WCB should guarantee defined benefit	Employer contributions should not fall below employees' contributions	Surplus belongs to plan members	Pensions should be indexed to inflation
—	Plan members should have at least joint control of WCB Fund	—	WCB Fund should remain separate from other funds

FIGURE 13.10

The OFL appears to want the best features of both asset related and defined benefit related pension deals, and none of the risk of either. The fact that it wants the employer to match or exceed employee contributions suggests that it also wants elements of a combined deal.

SECTION III

Changes Needed to the Pension Deal

This section recommends changes that should be made to the WCB pension deal to address problems we have identified and to respond to some of the comments from the OFL/CUPE.

Pension Fund Structure and Control

Currently, the WCB is both the employer and the pension fund governor. In Chapter 4, we recommend that public sector pension funds should be organized, to the extent practical, so that their activities are clearly separate from the employers and employees.

The Task Force is not able to determine to what extent a separation of roles is practical in the WCB's case. However, a separation of roles might be achieved in either of two ways:

- Establish a pension fund board (separate from the WCB Board) which would be responsible for the investment management of the WCB Fund. A minority of appointees would be plan members.
- Appoint a trust company as external trustee with full authority to make investment decisions.

Either option may require an amendment to the WCB Act.

If separation were not found to be practical, we believe this would in no way diminish the need for plan member involvement in investment decisions related to the WCB Fund.

Apart from those WCB employees who are involved in pension plan decision-making as part of their jobs, there are no WCB employees who participate in any aspect of pension plan decision-making.

We were struck, however, by how receptive the WCB is to the notion of having employees involved in the decision-making process. Indeed, such involvement would appear to complement the practices already in place to communicate with employees on a regular basis on all aspects of their pension deal.

There are a number of practical problems, in implementing employee involvement in investment decision-making. For example, how would one choose one or more employee representatives? To assume that a union official would be the obvious representative would ignore the fact that less than 50 per cent of plan members are members of a union. It also would suggest that the interests of union representatives are totally coincidental with the interests of other plan members (including retirees), a point which is not easy to determine.

Finally, there is the difficulty of selecting an employee representative who has sufficient investment knowledge or experience in order for him or her to make a meaningful contribution.

Recommendation 13.1

The WCB should review its pension fund structure:

- **If a separate board is established to be responsible for the investment management of the WCB pension fund, a minority of board members should be plan members or their representatives.**
- **If a separate board is not established, a minority of committee members on the Investment Advisory Committee should be plan members or their representatives for those matters involving the WCB pension fund.**

The WCB has informed us that it intends to consider the appointment of plan member representatives to the Investment Advisory Committee for that portion of the Committee's work which involves the WCB Fund.

The WCB has two funds – an accident fund designed to compensate injured workers and a pension fund designed to finance the cost of providing pension benefits to plan members. Until recently the accident fund was established under the Trustee Act but now is established under the Pension Benefits Act.

Presently, no distinction is made between the two funds by the members of those committees or by the WCB Board, insofar as their fiduciary responsibilities are concerned.

The Task Force believes that a clear distinction should be made between the two funds and that the members of the Investment Committee and Investment Advisory Committee be consistently conscious of that distinction.

Recommendation 13.2

The WCB Board, the Investment Committee and the Investment Advisory Committee should make a clear separation in their decisions between the WCB accident fund and the WCB pension fund.

Approval of Benefit Changes

The WCB Board has the authority to make practically all decisions in connection with the WCB pension plan, except improvements to benefit levels and changes to contribution rates.

Changes to benefits are initiated by WCB staff, who essentially track benefit levels in the Ontario public service. Once a benefit change has been approved by the WCB Board it is then submitted to the Ontario Government through the Minister of Labour, for approval by the Lieutenant Governor in Council.

The Task Force has been advised that any benefit changes are considered within a total compensation context.

While the WCB believes it is appropriate to have benefit changes ratified by the Lieutenant Governor in Council, it is concerned that a delay of up to six months can occur before a decision is made.

Recommendation 13.3

The decision-making process within the Ontario Government for considering changes to WCB pension benefit levels should be streamlined.

Conclusion

This chapter has reviewed the WCB pension deal. For the most part, current practice is reasonably well aligned with the formal WCB pension deal.

The chapter has reviewed the comments of the OFL and the Task Force's responses. Specific changes are recommended to address the problems we have identified and to respond to some of the concerns of the OFL.

CHAPTER 14

CANADA PENSION PLAN (CPP)

SYNOPSIS

The CPP is a national, partial pay-as-you-go, social insurance program. CPP contributions are a dedicated tax on all working Canadians and their employers. Since 1965, provinces have been entitled to borrow from the CPP Investment Fund on a pro rata basis relative to contributions. Ontario has borrowed about $16 billion. Ontario can continue to borrow captive CPP money or it can make this money available to the economy as a whole by investing its CPP funds in the capital market. The latter approach would serve two objectives: to invest in tangible, wealth-producing assets; and to demonstrate a willingness by the Government to compete with the private sector for this important source of savings. The Task Force recommends that all Ontario borrowings from the CPP Investment Fund be invested in market investments. An Ontario CPP Fund should be established to manage these investments.

Introduction

The Task Force's terms of reference call for an examination of the way in which Ontario invests amounts borrowed by it from the CPP Investment Fund.

CPP, TSF, PSSF and SAF cash flows have been Ontario's principal source of debt financing for over twenty years. Some see these captive funds as an advantage, enabling the Province to make investments in roads, hospitals, schools and other capital projects, while developing broadly based social programs. Others would prefer to see the borrowed CPP funds invested through the capital market and to allow the Province to manage its debt actively.

This chapter examines whether Ontario should continue to use the CPP Investment Fund as a captive source of borrowing or whether it should adopt a new policy and invest CPP funds through the capital market. In doing so, the chapter reviews the CPP deal and compares it to occupational pension plans.

Our focus is not to question the original arrangements which allow provinces to borrow from the CPP Investment Fund but to assess what Ontario should do with the money it borrows.

The chapter is divided into six sections:

I. **Nature of the CPP**

II. **Comparison of the CPP and occupational pension plans**

III. **Alternative policy objectives for Ontario's borrowing from the CPP Investment Fund**

IV. **Structure for an Ontario CPP Fund**

V. **Investment policy for an Ontario CPP Fund**

VI. **Implementation issues**

SECTION I

Nature of the CPP

The CPP is a joint federal/provincial program, established in 1965 as a compulsory and contributory social insurance scheme and funded on a partial pay-as-you-go basis. The program provides pension, death and disability benefits to contributors and their beneficiaries.[1]

The partial funding arrangement was a compromise between those who wanted the CPP to be funded in advance to avoid intergenerational transfers, and those who wanted the CPP funded on a pay-as-you-go basis. As part of the compromise, provinces were permitted to borrow surplus CPP funds on a pro rata basis relative to contributions.

CPP contributions are essentially a tax. After current pension benefits and administrative expenses are paid, the money can be borrowed by provincial governments for recycling back into the economy. To date, all surplus CPP funds have been recycled back into the economy through government expenditure programs and through Ontario HYDRO.

The basic features of the CPP are as follows:

- Contributions are made by all employed persons and their employers and by self-employed persons. Contribution rates are scheduled to increase gradually over the next 25 years (from 3.6 per cent of earnings up to a maximum related to the average industrial wage, in 1986, to 7.6 per cent of earnings up to a similar maximum in 2011). As more people become eligible for CPP benefits, the size of the CPP Investment Fund relative to annual benefits is expected to shrink from five times the current year's benefits, as at present, to two times the following year's benefits within about 20 years.

[1] Much of the analysis in this chapter is based on *Canada Pension Plan Fund: Options for Ontario*, Research Report #7 (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987).

- Benefits are based on earnings (not contributions), up to a specified maximum (currently $25,900). An individual's pension is not dependent on his actual contributions.
- Benefits are paid out of current contributions and investment earnings from earlier "surplus" assets.
- Surplus assets may be borrowed by the provinces on a pro rata basis at a rate equal to the average yield on long-term Government of Canada bonds.[2] This rate is lower than many provinces could obtain on their own credit. The federal government is the residual borrower if any province declines to take all its borrowing entitlement.
- All borrowings are for a 20 year term, with an option on the part of the federal government to call for repayment on six months' notice. This call feature has never been exercised.

How CPP Funds Are Borrowed

Figure 14.1 sets out the relationship among CPP contributions, investments and benefit payments.

CPP Contributions, Investments and Benefit Payments

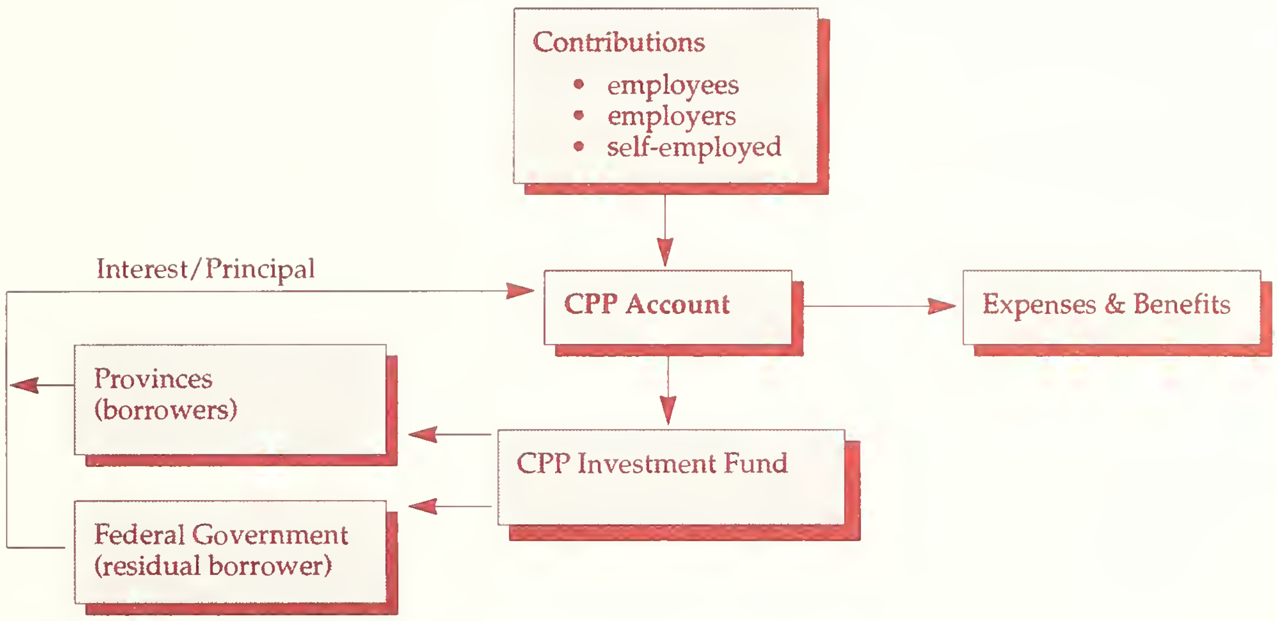

FIGURE 14.1

Contributions from employees, employers and the self-employed are collected by Revenue Canada and paid into the CPP Account. Expenses and plan benefits are paid out of that account. Any surplus assets are deposited in the CPP Investment Fund.

[2] Quebec established its own parallel plan, the Quebec Pension Plan (QPP). The Caisse de depot manages the investment of the QPP money. See Appendix I.

Each province may borrow from the CPP Investment Fund on a pro rata basis proportionate to the contributions made to the CPP Account by or on account of its residents. If a province does not borrow all of its borrowing entitlement, the federal government borrows the residual amount.

Ontario's Liability

Ontario's debt to the CPP Investment Fund as of March 31, 1987 was about $15.8 billion, of which $14.7 billion was on its own account and $1.1 billion had been borrowed by Ontario Hydro.

Figure 14.2 summarizes the past and projected growth in the CPP Investment Fund and Ontario's debt to the fund.

Growth in CPP Investment Fund and Cumulative Ontario Debt to CPP Investment Fund $ Billion

	1974/75	1979/80	1985/86	1986/87	2000 est.
CPP Investment Fund	9.4	18.1	32.1	34.3	74.0
Ontario Own-Purpose Debt to CPP Investment Fund	5.0	9.6	14.8	14.7	n/a
Ontario CPP debt for Ontario Hydro	0	0.5	1.0	1.1	n/a

FIGURE 14.2

Figure 14.3 summarizes the past and projected annual cash flow to the CPP Investment Fund, Ontario's CPP borrowing entitlement and Ontario's actual CPP borrowing.

CPP Investment Fund's Annual Cash Flow, Ontario's CPP Borrowing Entitlement and Ontario's Annual CPP Borrowing

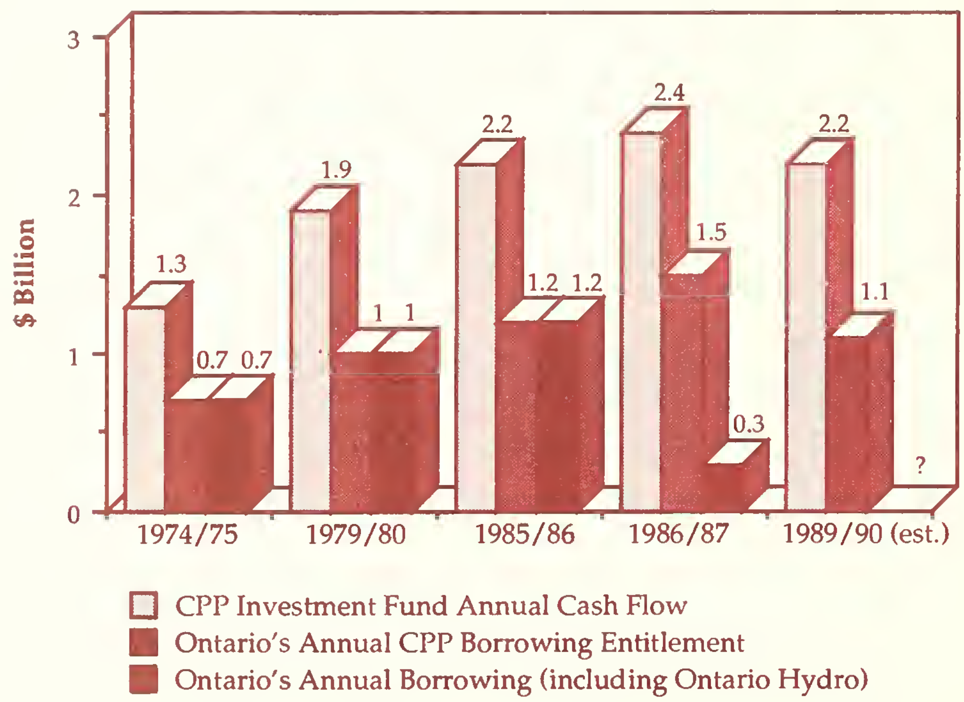

FIGURE 14.3

The future cash flow of the CPP Investment Fund (and therefore of Ontario's borrowing entitlement) gradually declines as benefit payments rise faster than contributions. This will result in a proportionately smaller fund relative to annual benefit payments, as was intended by the governments involved when they negotiated the schedule of future contribution rates that took effect in 1987.

Ontario has borrowed from the CPP Investment Fund to meet any net cash requirements remaining after it has used other captive funds, specifically the TSF.

In recent years, the rates of interest that Ontario has been required to pay on borrowings from the CPP Investment Fund have been lower than rates payable for borrowings from the TSF. However, the Ontario Government has not been able to take full advantage of this situation because it is required by legislation to borrow from the TSF; this has satisfied most of Ontario's net cash requirements.

In 1986/87, Ontario was entitled to borrow $1.5 billion from the CPP Investment Fund but borrowed only $232 million while repaying $333 million, thereby reducing its debt to the CPP Investment Fund, incurred for its own purposes, to $14.7 billion. However, Ontario Hydro borrowed a further $119 million, leaving Ontario's total CPP debt at $15.8 billion.

Ontario's recent practice of zero (or negative) net borrowing from the CPP Investment Fund has resulted in the federal government, as the residual borrower, significantly increasing the amount that it has borrowed from the CPP Investment Fund.

SECTION II

Comparison of the CPP and Occupational Pension Plans

The CPP differs from the occupational pension plans described in previous chapters. The principal differences are shown in Figure 14.4.

Comparison of Occupational Pension Plans with the CPP

Factors	Occupational Pension Plans	CPP
Membership/ Beneficiaries	Limited to employees of employers covered by each plan	Universal for all employed and self-employed individuals
Sponsor	Employer (or agent)	Federal Government
Benefits	Varies, up to 70% of salary	Up to 25% of the average industrial wage
Contributions	Employers and (maybe) employees	Matching employee/employer, or self-employed
Funding Level	Fully funded	Partial pay-as-you-go (small fund)
Liability for Pensions	Employer and/or employee, depending on deal	Federal Government
Subsidies	No significant subsidies	Intergenerational subsidy (current contributors pay for current pensions)
Impact of Investment Earnings	Over two thirds of total value of mature fund	Very small ultimate impact relative to total liabilities

FIGURE 14.4

The CPP is different from occupational pension plans in that:

- it is effectively a universal plan and contributions to it are for all intents and purposes a dedicated tax
- it is only partially funded
- the liability for any deficit rests with the federal government, not with employers or employees
- its surplus funds are made available to borrowers (the provinces) at rates which, depending on current market rates and each province's credit rating, may be below what they otherwise would pay.

SECTION III

Alternative Policy Objectives for Ontario's Borrowing from the CPP Investment Fund

For over 20 years, Ontario has used the CPP Investment Fund as a captive borrowing source.

Our terms of reference require us to review the present way CPP funds are invested by Ontario. In doing so, we focussed on two issues:

- First, given the availability of CPP funds for borrowing by Ontario, what would be the best, or most prudent, purpose to which these funds should be applied?
- Second, in light of the potential uses for borrowed CPP funds, should Ontario borrow from the CPP Investment Fund and, if so, how much?

Alternative Borrowing Objectives

Alternative borrowing objectives for use of borrowed CPP funds are of two broad types:

- Ontario could continue to use the CPP Investment Fund as a captive source of borrowing to finance government programs or capital spending, or
- Ontario could make available its share of CPP money to the economy as a whole by investing this money in the capital market.

Using the CPP Investment Fund as a captive borrowing source is looked at from two perspectives:

- First, by promoting economic development in the Province. Two ways this can be done are examined:
  - directly through government programs
  - indirectly through a government investment agency similar to the Caisse de depot et placement du Quebec.
- Second, by satisfying the Province's borrowing requirements – a debt management objective.

Economic Development Objective

Ontario can use monies borrowed from the CPP Investment Fund to achieve an economic development objective[3] in a variety of ways. For example:

- The Government could finance new public or private projects directly through government programs. The objective would be to invest in economic development projects which are currently not sufficiently attractive for private investors or which are traditional activities of government.

  The Ontario Federation of Labour argues that the CPP funds should be borrowed by the Government and invested to rebuild Ontario's infrastructure – hospitals, schools, highways, etc. – to an acceptable quality.

- Alternatively, the Government could pursue a more indirect approach similar to the way the Quebec Government's economic development objectives are served by the Caisse de depot et placement (Caisse).[4]

  While the primary objective of the Caisse is to make investments with a competitive rate of return, its secondary objective is to support economic development in Quebec. One way the Caisse supports its secondary objective is by providing a ready market for Quebec government, local government and Hydro Quebec bonds. This improves the liquidity of these bonds and thereby helps reduce the cost of borrowing.

  Another way the Caisse supports its secondary objective is through orienting its investments towards businesses in Quebec, provided that a lower rate of return does not result.

Two factors which support the adoption of the economic development objective are:

- Since the CPP is close to a universal program and since CPP contributions can be looked upon as a tax, there is a logic in using monies borrowed from the CPP Investment Fund to support government programs.
- Economic development programs, to the extent they improve the overall economy of the Province, would benefit Ontario residents who are CPP contributors.

Two factors which argue against adopting this objective are:

- First, the availability of CPP funds could result in the Government making expenditures it might not otherwise make. Such additional expenditures would increase the Provincial deficit.
- Second, the perception, and perhaps the reality, that borrowing by the Province outside the capital market to finance its programs reduces public understanding and Government accountability.

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[3] Some people may argue that investing in social development is equally as valid an objective as economic development. We have chosen not to enter into that debate.

[4] See Appendix I, *A Summary Description of the Caisse de depot et placement du Quebec.*

Few dispute that the Government has a role to play in enhancing the provincial economy. In our view, it is not appropriate for the Province to borrow captive CPP money specifically to pay for additional economic development programs. If the Province wishes to pursue such programs, it should borrow from the capital market in competition with the private sector.

As well, we do not recommend that Ontario establish an investment agency to make economic development investments at less than the going market rates of return, using borrowed CPP funds.[5]

Debt Management Objective

An alternative use to which captive CPP funds could be put is to meet the Province's borrowing requirements.

By borrowing from the TSF, PSSF, SAF and CPP Investment Fund to meet its cash requirements, Ontario has generally avoided borrowing in the capital markets on its own account.[6]

However, as shown in Figure 14.3, with the recent trend to lower deficits and the increasing amounts of money available from the TSF and PSSF, Ontario has not borrowed its full CPP borrowing entitlement. In 1986/87, Ontario reduced its total own-purpose CPP debt by over $100 million. The 1987 Ontario Budget forecasts no borrowing from the CPP Investment Fund in 1987/88.

In effect, Ontario's current strategy appears to be to borrow its CPP Investment Fund entitlement when needed and when available at attractive rates; that is, to use the CPP as a residual borrowing source. This means that the debt management objective is currently the main consideration in deciding whether to borrow from the CPP Investment Fund. If the TSF and PSSF are not to be invested through the capital market, there will continue to be little need for significant CPP borrowing to satisfy this objective.[7]

Several factors suggest that it is not desirable to follow the debt management objective:

- Ontario's pattern of borrowing from the CPP Investment Fund would likely be irregular. The federal government is required to borrow any amount not taken by Ontario. There could be demands for re-negotiation of the CPP borrowing arrangements, and consequent restriction of Ontario's borrowing flexibility, if the burden on the federal government of this variable (and relatively high cost) borrowing became too great.

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[5] *Canada Pension Plan Fund: Options for Ontario*, Research Report #7. (Ontario Task Force on the Investment of Public Sector Pension Funds, 1987.)

[6] The province has borrowed outside Canada on behalf of Ontario Hydro, as well as guaranteeing Ontario Hydro's debt.

[7] Of course economic circumstances could lead to larger deficits in the future, in which case the CPP Investment Fund again could become a major source of borrowing, if no other changes are made.

- Some in the financial community have suggested that surplus CPP funds could be used to re-purchase outstanding Provincial debt, in effect equivalent to issuing debt at one rate to retire debt outstanding at a higher rate. While this is a normal debt management procedure, it is of little practical value because there is relatively little Ontario market debt outstanding.

- Recent experience suggests that the greater flexibility provided by government borrowing through the capital market could reduce Ontario's borrowing costs. The interest rate on monies borrowed from the CPP Investment Fund is tied to long term federal bonds, which can at times be higher than short-term rates available to the Province. In this sense, the rigidities of Ontario's current borrowing arrangements are causing the Province to miss an opportunity to reduce its borrowing costs.

Ontario's current practice in using the CPP Investment Fund as a residual borrowing source is largely the result of statutory rigidities requiring the Province to borrow all funds available from the TSF, PSSF and SAF. Should these funds be invested in the capital market, all available CPP funds could be borrowed to meet the Province's financing requirements. This would remove the variability in Ontario's CPP borrowing.

Although this would be a practical option, it may not be the best course of action. Circumstances today give Ontario a clear opportunity to shift to market borrowing and thereby to achieve greater public understanding and Government accountability than can be achieved by continuing to use the CPP Investment Fund as a captive borrowing source.

Investment in the Capital Market

An alternative to the current policy of using the CPP Investment Fund as a captive borrowing source is to invest this money in the capital market. This would mean that:

- Recycled CPP contributions would be available to the economy as a whole, not just to the Government of Ontario.

- The Government would have to compete with the private sector if it wished to borrow CPP funds. Among other matters, this would strengthen the public's understanding of Provincial debt and the Government's accountability to the public for its debt management.

- CPP funds would be invested in the most economically efficient way. That is, the market would allocate the capital to its highest and best use and the overall impact on the economy would be positive and therefore supportive of economic growth. If the CPP funds were invested through an arms-length investment agency, that agency would no doubt invest in a wide range of non-traditional investments (such as venture capital investments), as OMERS, HOOPP and HYDRO do, to the benefit of the fund itself, the recipients of the investments, and the economy.

- If these investments result in a rate of return above the cost of borrowing, the Ontario taxpayer would benefit.

- Tangible wealth-producing assets which can be traded would stand behind Ontario's debt to the CPP Investment Fund.

Research conducted for the Task Force concludes that such investment, if properly phased, could be implemented without adverse effect on the capital market.[8]

Achievement of this objective would require a clear insulation of the investment process from Government direction (see Section IV).

In assessing the objective to invest CPP money through the capital market, three considerations should be kept in mind:

- To begin investing CPP funds through the capital market at the same time as the TSF, PSSF and SAF assets could involve transitional difficulties, such as:
  - lack of qualified staff and investment managers, and
  - constraints on the capacity of the market to absorb the additional funds without disruption, at least for a short period.

  Most of the briefs to the Task Force commenting on the CPP, as well as research conducted for the Task Force, suggest that such negative effects can be minimized through careful implementation planning.
- If borrowed CPP funds are not used for the Province's own purposes but are invested in the capital market, there would be no effect on any of the three measures of the Provincial deficit (see Chapter 5, Section IV). Such CPP borrowing would be accounted for as being owed by the agency charged with investing the CPP funds, in essentially the same way as for CPP funds borrowed by Ontario Hydro.
- Economic efficiency is unlikely to satisfy all of the Government's economic policy concerns – for example, regional or sectoral disparities. As noted in the earlier discussion on economic development, such concerns can be addressed through government programs.

Conclusions about the Alternative Borrowing Objectives

The Task Force has concluded that:

- Borrowing from the CPP Investment Fund to finance economic development:
  - could lead to expenditures that otherwise would not have taken place
  - increases the Provincial deficit
  - raises significant accountability problems.
- Continuing to borrow from the CPP Investment Fund for debt management purposes only:
  - would help cushion the financial impact on the Province of the transition to investing the TSF, PSSF and SAF through the capital market

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[8] *Public Sector Pension Funds and the Capital Markets,* Research Report #5. However, such a transition could occur simultaneously with growing buying pressure generated by other savings such as RRSP's and mutual funds, and would therefore require careful monitoring and reassessment of the asset mix.

- would not provide the flexibility, potential lower costs and public accountability which would result from borrowing through the capital market.

- Borrowing from the CPP Investment Fund and investing in the capital market:
  - would lead to greater economic efficiency and would promote economic growth
  - could be implemented without adverse effects on the capital market
  - would improve public understanding of the Provincial debt and the Government's accountability to the public for its spending and borrowing, because the Province would compete with the private sector for the funds it wished to borrow
  - would offer the prospect of a benefit to the Provincial taxpayer.

- If the Government does not wish to pursue the capital market objective, it should maintain the current debt management objective. It should not pursue the economic development objective simply because there is a captive borrowing source.

- If the Government elects to borrow captive CPP money in order to meet its net cash requirements, any residual CPP funds could still be available to be invested in the capital market. However, the Government should allocate a minimum of 50 per cent of its CPP borrowing entitlement to capital market investments in order to assure a significant flow of funds to the capital market.

Should Ontario Borrow CPP Funds?

Ontario could stop borrowing from the CPP Investment Fund altogether and meet all of its borrowing requirements through the capital market or other sources.

In effect, this option would leave to the federal government the decision on how Ontario's share of CPP funds should be used. Presumably the federal government would use these funds to help meet its own borrowing requirements, as it does now when Ontario does not borrow all of its share.

We have rejected this option for two reasons:

- First, we believe CPP funds should be recycled back into the economy as a whole, not just through government expenditures. If Ontario decided not to borrow from the CPP Investment Fund, the federal government would borrow the available money and recycle the funds back into the economy through its expenditure programs.

- Second, we believe that Ontario has the opportunity, through investment in the capital market, to foster economic growth and development beyond the level that otherwise would occur. This is because a substantial portion of the market investments of an Ontario CPP fund would be in equities and non-traditional investments.

Since the opportunity of investing its share of CPP funds in the capital market is now open to Ontario, and in light of the advantages to the economy of such

investment, we believe all available CPP funds should be borrowed and invested in the capital market.

As noted, if the Government decides to continue using CPP funds as a captive borrowing source to help meet its net cash requirements, it should ensure that at least 50 per cent of available CPP funds are allocated for investment through the capital market.

Recommendation 14.1

The Ontario Government should borrow its entire CPP borrowing entitlement for investment in the capital market in order to increase economic efficiency and foster economic growth.

Recommendation 14.2

The Government should not borrow captive CPP funds to subsidize economic development projects or programs. If the Government wishes to undertake economic development projects and needs to borrow to finance them, this borrowing should be done in the capital market in competition with the private sector.

In considering any new investment approach for monies borrowed from the CPP Investment Fund, it should be stressed that there would be no effect one way or another on pensions paid to CPP beneficiaries.

SECTION IV

Structure for An Ontario CPP Fund

If the Government wishes to reinvest monies borrowed from the CPP Investment Fund through the capital market, it is important that the investment management structure be consistent with the capital market objective.

Three possible structures are:

- In-house portfolio investment
- Investment by external managers
- Investment through an arms-length organizational structure similar to OMERS.

In-house portfolio management is used in some other jurisdictions.[9] However, this approach has disadvantages, including:

[9] For example, British Columbia and some other provinces for the investment of public sector pension funds. See *Description of Pension Fund Arrangements in Other Jurisdictions*, unpublished Background Paper #3, and Appendix B of *Pension Fund Structure*, Research Paper #2 .

- civil service salary scales make it difficult to attract and retain high quality investment staff, and
- there is a perception of a lack of independence from Government direction in investment decision making.

These disadvantages could be partly overcome if investments were made through external (private sector) investment managers reporting to Treasury officials. However, effective investment through the capital market requires both the perception and the reality of separation from political direction and control. The external investment manager option is available with any other structure.

Creation of an arms-length agency to manage the investments would be most effective in meeting the capital market objective. Within this option, various degrees of independence from the Government can be considered, such as:

- broad but clear investment policy direction from the Government, with no interference in actual investment decisions
- an understanding between the Government and the agency, similar to the arrangement whereby the Caisse purchases a significant proportion of Quebec government and Hydro Quebec bonds
- no involvement by the Government either in investment policy decisions or in investment implementation, similar to the OMERS model.[10]

Only the third model would permit investment policy decisions fully focussing on rate of return.

An alternative arms-length approach would be to assign responsibility for the investment of monies borrowed from the CPP Investment Fund to the agency investing the PSSF in the capital market (see Chapter 8). Some relevant considerations are:

- Funds managed by the Caisse (which are invested by internal managers) are reported to have investment management costs of less than seven basis points (0.7 per cent of assets under management). This is about the same as the investment management costs of OMERS, HOOPP and HYDRO.[11]
- It is unlikely that significant additional economies of scale arise once funds grow larger than $1 billion.
- The PSSF and the Ontario CPP Fund would each be large enough to invest on their own.
- The PSSF and the Ontario CPP Fund would have quite different underlying deals and liability structures. If the assets were segregated, different asset mix policies could be pursued for each, but this may require additional investment management staff, offsetting any financial advantages of centralizing the investment management of the two funds.

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[10] The reference is to the autonomy of OMERS with respect to investments in the capital markets. Changes to OMERS benefits and employee contributions require government approval.

[11] See Chapter 15.

On balance, the Task Force believes that a separate Ontario CPP investment agency is preferable to assigning investment responsibility to the proposed PSSF investment agency.

Recommendation 14.3

An Ontario CPP Fund should be established at arms length from the Government, with its own board appointed by the Lieutenant Governor in Council and responsible for the investment through the capital market of monies borrowed by Ontario from the CPP Investment Fund.

This agency would parallel those set up to manage the investment of the TSF and PSSF in the capital market.

SECTION V

Investment Policy for An Ontario CPP Fund

Earlier chapters stressed the importance of understanding the pension deal and the nature of the plan liabilities when determining an investment policy for a pension fund.

This section examines such considerations in connection with an investment policy for investing monies borrowed from the CPP Investment Fund.

What Kind of Deal?

Clearly, investing monies borrowed from the CPP Investment Fund involves a very different deal from that of an occupational pension plan.

The most important difference is that the liability to be covered is the principal and interest payable on the monies borrowed, not the underlying CPP benefits themselves. This liability rests with the federal government.

Provincial debt to the CPP Investment Fund has a six-month call option. However, this call option has not been exercised to date. In the unlikely event that it is exercised in the future, Ontario would have the choice of liquidating some of the investments in the Ontario CPP Fund or covering the call through other borrowing. We do not believe that the six-month call feature is significant enough to affect the investment policy decisions for an Ontario CPP Fund.

In Whose Interest?

The investment risk and reward of investing in the capital market monies borrowed from the CPP Investment Fund rests with the Ontario Government on behalf of the Ontario taxpayer. It is therefore in the taxpayer's interest that these investments would be made.

There would be no direct impact on CPP beneficiaries and they would not have a stake in the investment decision.

The CPP Investment Fund would have a creditor's interest which would be secured, as at present, by the covenant of the Ontario Government.

Who Decides?

Given the particular deal described above, the party bearing the investment risk would be the Province, on behalf of the Ontario taxpayer. Although investment policy should be decided by the Board of Governors of the Ontario CPP Fund, there should be a mechanism by which the Government could advise the Board of the Province's risk tolerance. This mechanism should be set out in the enabling legislation, which should also make it clear that the Government is not entitled to give direction on specific investments.

The funds invested would not be pension funds per se, and the Pension Benefits Act, 1987 would not apply. Nevertheless, the Ontario CPP Fund should be required to abide by fiduciary standards similar to those set out in the Pension Benefits Act, 1987. These standards could be reinforced in the enabling legislation.

Investment Policy Models

Under the recommended approach, the Board of Governors of the Ontario CPP Fund, and not the Government, would set the fund's investment policy.

It may be useful, however, to examine some of the features of the investment policies set by investment agencies with similar mandates. Two relevant models are the Caisse and OMERS.

Figure 14.5 provides comparative information relating to the Caisse, OMERS and an Ontario CPP Fund.

Comparison of the Investment Features of Quebec's Caisse de Depot General Fund, the OMERS Fund and a Potential Ontario CPP Fund

December 31, 1985

	Assets ($ Billion)	Cash Flow ($ Billion)	Asset Mix				Time-Weighted Rate of Return (1975-1985)
			Bonds	Stocks CDN	Stocks Foreign	Other	
Caisse's General Fund*	15.5	1.4	70%	15.8%	1.5%	12.7%	13.7%
OMERS**	7.0	0.9	36.4%	24.0%	12.1%	27.5%	12.5%
Potential Ontario CPP Fund	NIL	1.2 (potential)	—	—	—	—	—

* QPP Fund assets make up about 80 per cent of the Caisse's General Fund
** OMERS includes the assets of CAATS and the Ryerson Pension Fund

FIGURE 14.5

Clearly, there are differences in asset mix and in investment performance, between the Caisse and OMERS. The circumstances of each bear examination.

Caisse

The QPP is a direct depositor into the Caisse. There is no intermediate borrowing step.

The current asset mix policy for the Caisse's General Fund is about 70 per cent bonds, 17 per cent equities and 13 per cent other investments. The proportion of bonds is higher than for the Caisse's investment of the public sector employee pension plans, reflecting the objective of supporting Provincial borrowing through the General Fund. An unusually high rate of return on bonds over the past five years has therefore had a positive impact on the General Fund's overall rate of return.

The Caisse invests a larger proportion of its equities in Canadian companies than does OMERS. Foreign investments are the only investments which the Caisse does not manage internally.

The Caisse also invests to a significant extent in smaller companies and in various non-traditional investments, both to earn an attractive rate of return and to support economic development. The General Fund takes roughly half of each of the Caisse's investments in small and medium enterprises.

OMERS

A description of OMERS and its investments is found in Chapter 10.

Like the Caisse, OMERS manages almost all its investments internally.

Although 18 per cent of its portfolio is still in non-market government debentures, OMERS invests a considerable proportion of its assets in bonds, including government bonds. Its overall bond/equity split and investment performance are close to the median of the PFA/SEI survey.[12]

OMERS has made relatively large investments in such non-traditional areas as real estate, oil and gas properties, and venture investing. In its diversification strategy, OMERS has concluded that the potential rates of return from such investments will offset reduced liquidity, higher transaction and administrative costs and probably higher risk.

An Ontario CPP Fund

While the investment risk policy (including asset mix) of the Ontario CPP Fund would be the responsibility of its Board, we anticipate the fund would have an asset mix somewhere between the Caisse de depot's General Fund and OMERS. (See Figure 14.5.) That is, it would likely have fewer bonds, more equities and a higher percentage of non-traditional investments than the Caisse.

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[12] However, OMERS invests a higher proportion of its assets in other investments (including mortgages) than the median private sector fund. The PFA/SEI survey is a pension fund performance measurement service.

Specifically, we would anticipate that an Ontario CPP Fund would:

- have a diversified portfolio;
- hold some Ontario bonds but not a disproportionate amount.[13] It should not be expected to hold anything close to 70 per cent of its assets in bonds, as does the Caisse de depot's General Fund;
- use internal investment managers (although part could be managed externally at the start, and specialized investments might continue to be best managed externally);
- make significant non-traditional investments.

However, to reiterate, decisions on investment policy and the implementation of investment policy would rest with the Board of Governors of the Ontario CPP Fund.

Recommendation 14.4

The Board of Governors of the Ontario CPP Fund should determine the investment policy for monies borrowed by Ontario from the CPP Investment Fund and invested in the capital market.

SECTION VI

Implementation Issues

A detailed implementation plan for an Ontario CPP Fund is beyond the scope of this Report. However, some of the issues to be resolved during implementation planning are as follows:

- How should the Board of Governors be held accountable? Is investment performance the key measure? What reporting/disclosure methods should be followed? To whom should the Board report?
- Should investment standards similar to those in the Pension Benefits Act, 1987 be established for the Board? If so, should these standards be prescribed in the enabling legislation?
- Should the monies borrowed from the CPP Investment Fund be the responsibility of an agency with other responsibilities, e.g., the agency to be charged with investment of the PSSF? If so, would this arrangement be temporary or permanent? If separate agencies are created, how would transitional problems be handled, such as:
  - availability of qualified staff and/or external investment managers, and

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[13] This reflects the consensus in the briefs and the research conducted for the Task Force, that should Ontario decide to change its borrowing strategy and borrow predominantly through the capital markets, it should have no difficulty marketing its debt at competitive interest rates.

  - phasing in of investments by three new Ontario investment funds (TSF, PSSF and CPP)

- If the Ontario CPP Fund earns a higher rate of return than the cost of borrowing from the CPP Investment Fund, the resulting net return is to the credit of the Ontario taxpayer. Should net returns be retained and reinvested in the fund – perhaps against the proverbial rainy day? Or should dividends be paid to the Province on an ongoing basis? In the latter case, how much of a contingency reserve should be retained against future periods of low investment returns?

The Task Force is confident these issues, and others which may be encountered, can be resolved successfully during a careful implementation process.

Chapter 15 sets out an implementation structure and process for shifting from non-market government debt to market investments.

Conclusions

This chapter has reviewed the CPP deal. It has assessed three possible investment objectives for Ontario to follow when borrowing from the CPP Investment Fund and has recommended that monies borrowed from the CPP Investment Fund be invested in the capital market. It has reviewed possible structures for an Ontario CPP Fund and considerations in developing an investment policy. It has also identified some implementation issues.

The Task Force recommends that Ontario invest its entire CPP borrowing entitlement in the capital market. Investment decisions should be made by an independent investment agency. The Province's financial requirements should be met through borrowing in the capital market. However, if the Government wishes to have the option of first access to CPP funds for its own-account borrowing, it should leave at least 50 per cent of available CPP funds for investment in the capital market.

CHAPTER 15
IMPLEMENTATION

SYNOPSIS

Changes in legislation will be required to implement our recommendations. A review process should be put in place following release of our report. The organizational, staffing and investment implications of our recommendations suggest the need for a phased approach.

Introduction

This chapter discusses the implementation implications arising from our recommendations with respect to the seven pension funds included in our terms of reference and for the CPP. The chapter offers suggestions only and should not be regarded as a detailed implementation plan.

The chapter is divided into four sections:

I. **Changes to legislation and regulations**

II. **Organizational and staffing implications**

III. **Phasing: non-market to market investments**

IV. **Implementation co-ordination**

SECTION I

Changes to Legislation and Regulations

This section discusses the principal changes to legislation and regulations that we foresee for the seven pension deals we have been asked to examine and for the investment of CPP funds.

Given our recommendations in earlier chapters, we anticipate that at least five Acts will need to be amended, namely:

- the Teachers' Superannuation Act
- the Public Service Superannuation Act
- the Superannuation Adjustment Benefits Act
- the Ontario Municipal Employees Retirement System Act

- the Power Corporation Act

In addition, a new act to establish an agency to invest Ontario's CPP funds will be required.

Figure 15.1 illustrates the principal changes to be made to existing legislation. The changes assume that the employer/plan sponsor will continue to be responsible for any deficit in the TSF and PSSF, except for the employees' liabilities related to the SAF if it is merged with the base funds.

Principal Legislative Changes to the TSF, PSSF, SAF, OMERS and HYDRO Acts

Issue	TSF Act	PSSF Act	SABA Act	OMERS Act	HYDRO Act
Structure of Fund	Change Sec. 64 (1)	Change Sec. 5	Repeal Current Act and Merge SAF with TSF, PSSF and Ryerson Funds	—	—
Appointment Process	New	New		Regulation under Sec. 14	—
Appointments	New	New		—	—
Custodian	Change Sec. 64(2)	Change Sec. 32		—	Change Sec. 20 (8)
Trustee	New	New		—	?
Investment Policy Maker	Change Sec. 72	New		—	?
Investment Policy	Change Sec. 72	Change Sec. 5 (1,4)		—	—
Investment Manager	Change Sec. 72	New		—	New Section
Surplus/ Deficit	New	New		New	—
Changing the Deal	Various Options	Various Options		Regulation	Change Sec. 20 (7)
Funding Policy	Change Sec. 5	Change Sec. 5 (2)		Legislation/ Regulation	—
Actuary	Change Sec. 64 (3)	Change Sec. 5 (5)		—	—
Cost of Admin.	New	New		—	—

FIGURE 15.1

Teachers' Superannuation Act

Changes will be required to the Teachers' Superannuation Act, 1983 to establish the TSF as an arms-length fund and to implement the other changes recommended by the Task Force. These include amendments relating to:

- the appointment of the TSF Board of Governors and custodian
- the assignment of investment policy and investment management responsibility to the TSF Board of Governors
- the authority of the TSF Board of Governors to invest in market investments and to delegate investment management responsibility
- the process for changing such components of the pension deal as the funding and benefits policies
- the appointment of an actuary for the TSF
- the ownership of a surplus in the TSF
- the payment of the cost of investment management and fund administration out of the TSF.

Public Service Superannuation Act

Changes will be required to the Public Service Superannuation Act, 1983 to establish the PSSF as an arms-length fund and to implement the other changes recommended by the Task Force. These include amendments relating to:

- the appointment of the PSSF Board of Governors and custodian
- the assignment of investment policy and investment management responsibility to the PSSF Board of Governors
- the authority of the PSSF Board of Governors to invest in market investments and to delegate investment management responsibility
- the process for changing such components of the pension deal as the funding and benefits policies
- the appointment of an actuary for the PSSF
- the ownership of a surplus in the PSSF
- the payment of the cost of investment management and fund administration out of the PSSF.

Superannuation Adjustment Benefits Act

This Act should be repealed and the appropriate assets of the SAF allocated to the TSF, PSSF and the Ryerson pension funds. A decision on how the unfunded future obligations of the SAF should be dealt with will be required.

Ontario Municipal Employees Retirement System Act

Changes are required to the OMERS Act and regulations to realign the representation on the OMERS Board to be consistent with the formal pension deal,

and to permit changes to benefit levels and contribution rates without an amendment to the OMERS Act.

Power Corporation Act

Changes are required to the Power Corporation Act to remove all but the enabling provisions for the HYDRO plan and fund, which would then be administered solely in accordance with the Pension Benefits Act, 1987 and not be constrained by the Power Corporation Act.

A New Ontario CPP Fund

A new Act establishing an Ontario CPP Fund would be required. The legislation establishing the Caisse de depot et placement du Quebec would provide a helpful model for how an Ontario CPP Fund might be structured.

SECTION II

Organizational and Staffing Implications

This section focuses on some of the organizational, staffing and cost implications of establishing separate organizational structures to invest the assets of the TSF, PSSF and CPP in market investments.

We have assumed that there will not be a separate organizational structure to invest the assets of the SAF. These assets would be merged, as appropriate, into the TSF, PSSF and the Ryerson funds and invested by those funds.

Organizational Principles

The following principles should guide the selection of staff and the organization of any new or existing large public sector pension fund:

- Because large and increasing amounts of money are involved, the fund probably should be invested primarily by internal investment managers. However, the actual decision on internal vs. external investment managers should be made by the governors of the fund.

- The investment managers recruited should have outstanding ability, training and experience.

- Subject to the investment policies established by the fund's governors and investment policy committee, the investment managers should be free to invest, according to their judgement, without unnecessary restrictions.

- The investment performance of the fund's investment managers should be appraised regularly by an independent firm engaged in the measurement of rates of return.

- Investment policy and investment strategy must be based on thorough economic analysis and financial research and on ongoing consultation with investment specialists throughout the investment community. Such

analysis, research and consultations are essential if above average performance is to be achieved.

- The compensation for the fund's investment managers must be competitive with that of funds of similar size in both the public and private sectors.
- No political direction as to the types of investment should be given to the fund.
- The fund's base of operations should be located away from Queen's Park and any other government location.

Organizational Structure

Figure 15.2 illustrates a model organizational structure designed to establish responsibility and accountability for the fund's investment policies and investment management. The structure is based on the assumption that the fund will invest in a complete range of market investments.

Model Investment Organization

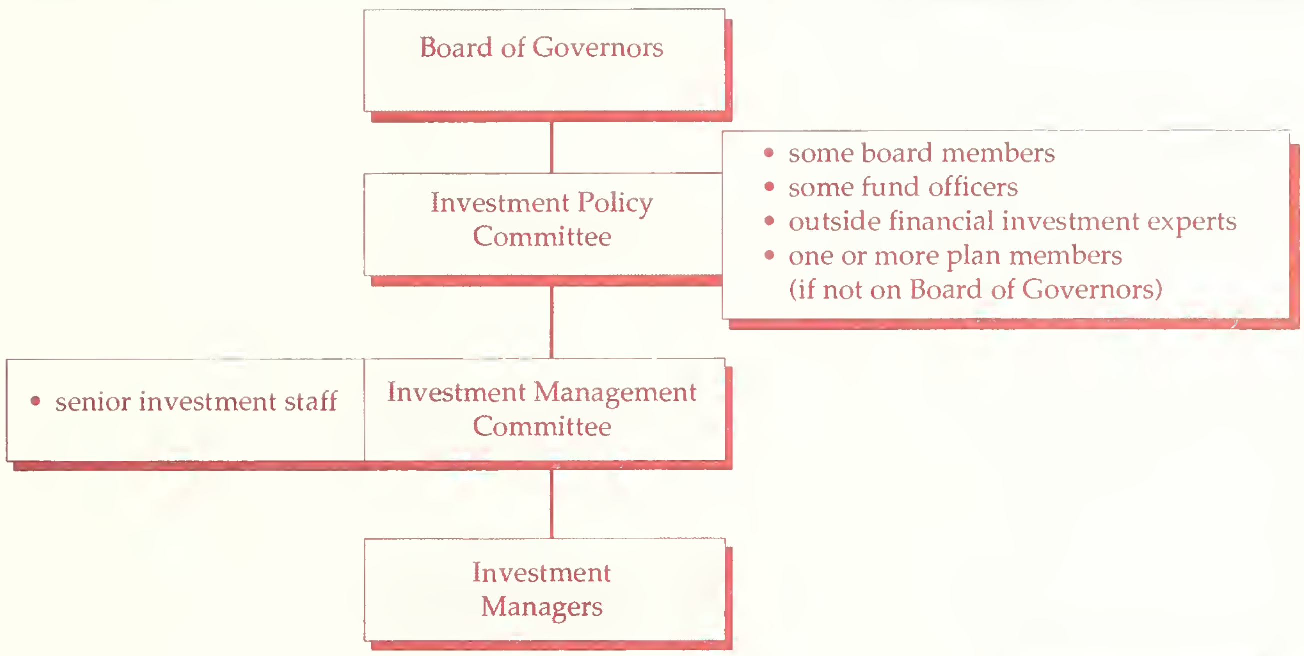

FIGURE 15.2

The fund's organizational structure should be composed of the fund's Board of Governors, an Investment Policy Committee and an Investment Management Committee.

The following briefly describes the composition, role and responsibilities of each.

Board of Governors

The Board of Governors would be accountable to a variety of individuals and groups. For example, the TSF and PSSF Boards of Governors would be accountable to a Minister, to plan members and to the public.

Composition:

- The members of the Board would be appointed by the Lieutenant Governor in Council and should be of the highest quality and integrity. Included on the Board would be representatives of active plan members and retirees, where applicable. In the case of the CPP Fund there would be no need for such special representation. The control of the appointments to the Board should be in the hands of the party who bears the investment and actuarial risk.

Roles and Responsibilities:

- To manage the business and affairs of the fund
- To determine the appropriate level of investment risk for the fund
- To set the investment policy of the fund, including the asset mix policy and the rate of return expectations.

Investment Policy Committee

Composition:

- The Investment Policy Committee should be composed of a select group of Board members, senior investment staff members and outside financial experts. The Committee should have eight to ten members. (If plan members are not appointed to the Board of Governors, one or more plan members should be appointed to the Investment Policy Committee.)

Roles and Responsibilities:

- To recommend to the Board a statement of investment policy, including asset mix policy and rate of return expectations.
- To devise a strategy for investing available funds.
- To develop a statement of investment powers to be delegated to the investment managers, including those powers to be exercised only with the approval of the Committee.
- To report to the Board on investments that require Board approval.
- To report on the performance of external investment managers, excluding mutual funds.
- To examine all investments of a type or form not previously included in the portfolio.
- To advise on the hiring of consultants or advisors.
- To report on the formation of any wholly-owned subsidiary company in relation to a specific investment.

Investment Management Committee

Composition:

- Senior investment managers responsible for investments in debt, equity, property, venture capital etc., including a representative from the policy and research staff.

Roles and Responsibilities:

- To develop investment recommendations for the Investment Policy Committee.
- To ensure that the strategies approved by the Investment Policy Committee are carried out.
- To supervise, in a general way, the selection, timing and execution of purchases, sales, exchanges, etc.

We estimate it will take up to six months from the date any necessary legislation is passed to organize and staff a new fund so that it has the capacity to begin making investments.

Investment Management Costs

Establishing and maintaining new investment funds for the TSF and PSSF will be expensive. This fact notwithstanding, the TSF and the PSSF will be better off investing in diversified market investments than in non-market government debt, since the additional investment management costs as a percentage of assets invested can be expected to be much smaller than the increased return from a diversified portfolio.

Figure 15.3 compares the 1985 investment management costs of the three largest Ontario public sector pension funds investing in market investments with the Caisse de depot et placement du Quebec. It also shows the estimated investment management costs the CAATS Fund would incur if it separated from OMERS and retained external investment managers.[1]

Comparison of Investment Management Costs and Number of Staff

Fund	1985 Investment Expense* ($ Million)	1985 Assets ($ Billion)	Expense/Asset Ratio	1987 Investment Staff
HOOP**	2.0	2.9	0.007	16
HYDRO***	2.0	2.9	0.007	17
OMERS	4.6	7.0	0.0066	50
CAISSE	16.2	25.2	0.0064	n/a
CAATS (est.)	1.4 to 2.1	0.7	0.02 to 0.03	external managers

* Does not include transaction costs.
** Includes the cost of central services provided to the investment function. Includes secretarial/clerical support.
*** Does not include secretarial/clerical support but does include the cost of central services provided to the investment function.

FIGURE 15.3

[1] *Pension Study for the College of Applied Arts and Technology (CAATS), 1986.* Prepared by Sedgwick Tomenson Associates and Frank Russell Canada. Page VI-1.

Generally, the cost of maintaining an investment management organization will depend on the size of the assets to be invested, the composition of the investment portfolio and the extent of the fund's resources, such as the economic and financial analysis it chooses to employ.

For comparative purposes, such costs are usually stated as a ratio to the total assets of the fund. The three largest Ontario public sector pension funds which invest in market investments and which have internal investment managers have costs of approximately 0.7 per cent, about the same as Quebec's Caisse de depot. A consultant's estimate of the investment management cost for the CAATS Fund, if it were separated from OMERS, was about three to four times higher, assuming external investment managers were engaged.

SECTION III

Phasing: Non-Market to Market Investments

It will take some time to create three new funds able to invest in a diversified portfolio of market investments.

Figure 15.4 looks at a possible schedule and suggests that there should be six phases leading up to the time when a new fund is in a position to invest all of the money available to it.

Review, Legislative, Organizational and Investment Phases

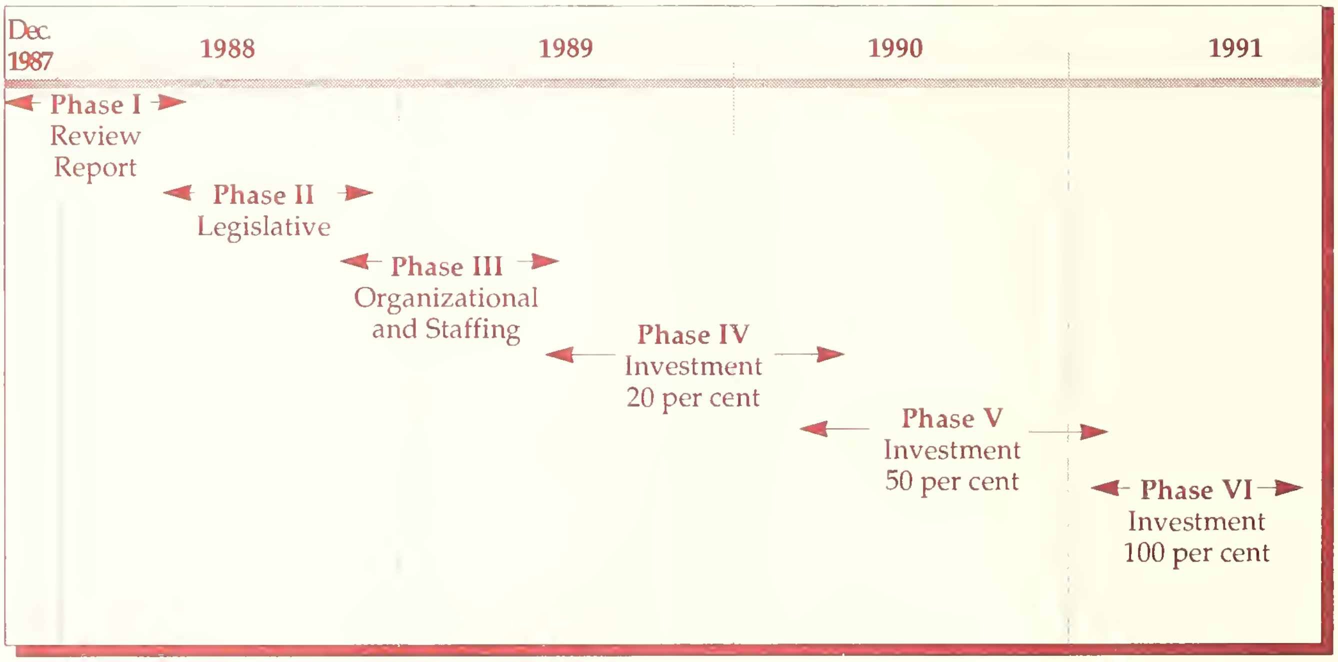

FIGURE 15.4

Phase I – Public review and comment on the Task Force's report December 1987 through February 1988:

This phase could take three to four months. It would involve review and comment by the public on the Task Force's recommendations.

Phase II – Legislation Phase, March through September, 1988:

This phase would involve the preparation and approval of the necessary legislation. It is estimated that the earliest that legislation could be passed is the Summer or Fall of 1988.

Phase III – Organizational and Staffing Phase, September, 1988 through April, 1989:

Following the passage of the legislation, organization and staffing for the new funds could begin. This phase could be complete and investment could start by about April 1989.

Phases IV, V and VI – Investment Phase, starts April, 1989:

Investments would be scaled up over a three year period as follows:

- from April 1989 to March 1990, the fund would invest up to 20 per cent of the money available to it.
- from April 1990 to March 1991, the fund would invest up to 50 per cent of the money available to it.
- from April 1991 onward, the fund would invest up to 100 per cent of the money available to it.

In our view, it would not be desirable for a large fund to begin investing immediately all the money available to it. The reasons for phasing include:

- the need to build an investment team carefully
- the large sums of money involved and the many complex administrative problems involved (See Figure 15.5).
- the risk of market distortion if funds are placed too quickly in the market.

Phased Investment by the Teachers' Superannuation Fund 1989-1992

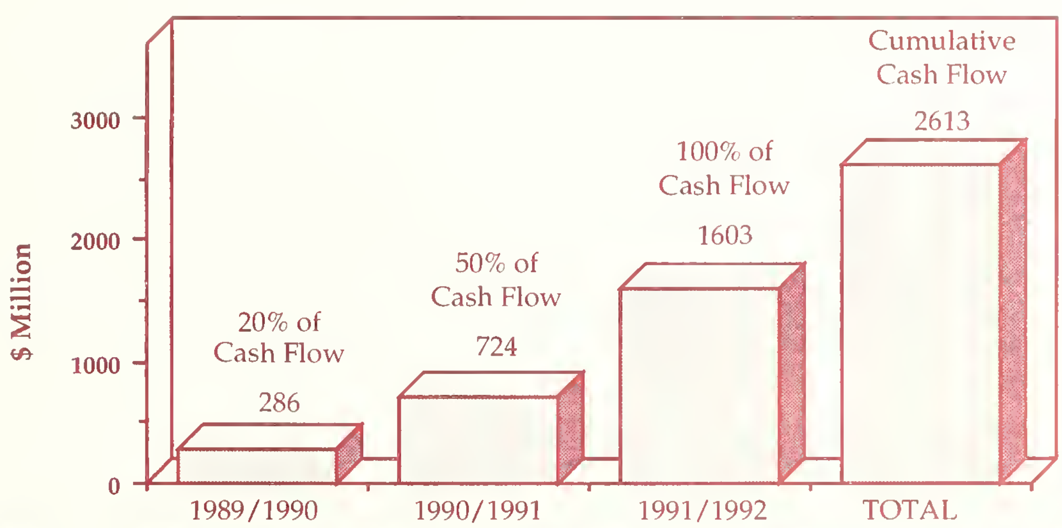

FIGURE 15.5

Figure 15.6 is an estimate of the money which would be available for investment over the three-year period for each of the TSF, the PSSF, the SAF and Ontario CPP funds, assuming a scaling-up approach.

Estimate of Cash Flow Available for Investment Over the Period 1989 to 1992 if Market Investments Phased

Fund	1989/90 20% ($ Million)	1990/91 50% ($ Million)	1991/92 100% ($ Million)	TOTAL ($ Million)
TSF	286	724	1,603	2,613
PSSF	110	274	544	928
SAF	42	82	171	295
CPP	196	474	946	1,616
TOTAL	733	1,712	3,582	5,452

FIGURE 15.6

Figure 15.7 illustrates that the taxpayer could potentially save $1.2 billion over the 10 year period – 1989-1999 – if the cash flow of the TSF, PSSF, SAF and Ontario's CPP borrowing entitlement were invested in market investments and earned, on average, an additional one per cent risk-related rate of return.[2] If the available cash flow grew by 5 per cent per year and earned, on average, an additional one and a half per cent risk-related rate of return, the potential saving could be $2.2 billion over the ten years.

Comparison of the Estimated Additional Savings to the Taxpayer as A Result of Investing the Cash Flow of the TSF, PSSF, SAF and Ontario's CPP Entitlement in a Diversified Portfolio Over a Ten Year Period, 1989 to 1999

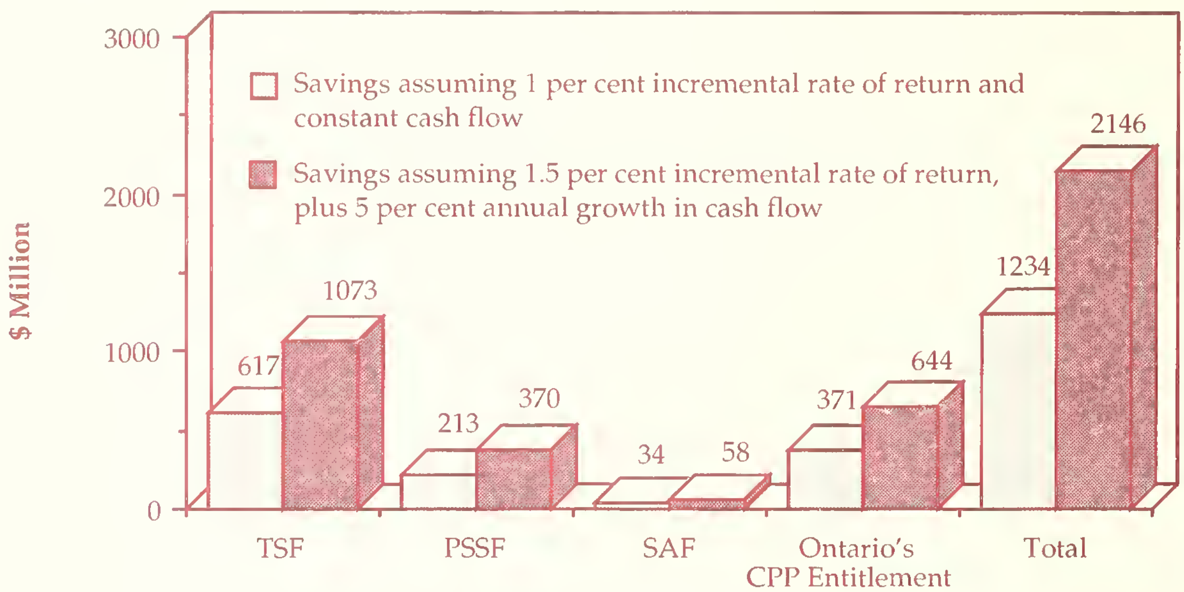

Figure 15.7

[2] This calculated saving assumes phasing-in of the investment of the cash flow in market investments over the first two years, with all of the cash flow being invested in the succeeding eight years. It assumes a constant total cash flow for the last eight years.

The saving over the 10 year period could well be higher than shown in Figure 15.7 because:

- the cash flow of the funds is expected to increase significantly over this period
- existing non-market government debt will mature and be reinvested in market investments
- the additional rate of return from market investments would likely be higher than one per cent.

Initially, external investment managers and specialists should be engaged to advise, train and assist the funds' internal investment managers.

During this phasing-in period, the portion of available money not invested in market investments would continue to be invested in non-market government debt. In the case of Ontario CPP funds, the available money not invested in market investments could be used either by the Province for debt management purposes or not borrowed from the CPP Investment Fund in the first place.

Recommendation 15.1

The implementation of the Task Force's recommendations be divided into at least six phases including:

- **a public review and comment phase**
- **a legislation preparation and approval phase**
- **an organizational and staffing phase**
- **three investment phases over a three-year period**

SECTION IV

Implementation Co-ordination

This section deals with the discussions and processes we believe would be desirable following the release of our report.

Our approach has been to provide a framework to help assess the logic of a particular pension deal and to compare current practice with the formal deal.

For the most part, we anticipate broad support for such recommendations as:

- not further centralizing the investment management of public sector pension funds
- investing in market investments
- establishing the TSF and PSSF at arms length from the Government
- using financial or economic criteria in making investment decisions
- seeking to achieve greater flexibility in ways to change the deal.

Some of our other recommendations may not be welcomed by all.

The implications of our recommendations will take time to assess. Various stakeholders will no doubt comment on our report.

In our view, the primary responsibility within the Government for the seven pension deals we were asked to examine should be assigned to individual ministries.

Recommendation 15.2

The primary responsibility for issues related to the implementation of recommendations for specific public sector pension plans should be delegated to the Ministry most directly connected to the employer/plan sponsor for each plan.

This would mean that:

- The Ministry of Education should be responsible for issues related to the TSF. The Ministry of Treasury and Economics should continue its custodial responsibility for the remaining non-market government debentures.
- The Human Resources Secretariat of Management Board, in cooperation with the Ministry of Education for the TSAF and the Ministry of Colleges and Universities with respect to the Ryerson Fund, should be responsible for issues related to the PSSF and the SAF. The Ministry of Treasury and Economics should continue its custodial responsibility for the remaining non-market government debt.
- The Ministry of Municipal Affairs should be responsible for issues related to the OMERS Fund.
- The Ministry of Energy should be responsible for issues related to the HYDRO Fund.
- The Ministry of Health should be responsible for issues related to the HOOPP Fund.
- The Ministry of Labour should be responsible for issues related to the WCB Fund.
- The Ministry of Colleges and Universities, in co-operation with the Ministry of Municipal Affairs, should be responsible for issues related to the CAATS and Ryerson Funds.

With the number of ministries involved in implementation and the need to respond to stakeholder comments following the release of our report, we recommend the Government designate a central agency with overall responsibility for co-ordinating the implementation process.

Recommendation 15.3

The Government should assign to a central agency, preferably Cabinet Office, the overall responsibility to co-ordinate the activities of individual ministries affected by the Task Force's recommendations and to receive comments on those recommendations.

CHAPTER 16

SOME CONCLUDING COMMENTS

SYNOPSIS

This chapter examines the Task Force's recommendations in light of the current climate. It also looks at some trends which could affect public sector pension funds in years to come.

Introduction

The chapter is divided into two sections:

I. A Current View

II. A Prospective View

SECTION I

A Current View

At the outset of this report, we identified nine public sector pension fund issues. These are summarized, along with comments received in briefs, in Chapter 2.

This section looks at Ontario's public sector pension funds and at our work over the past year from a different point of view. The objective is to describe the environment in which many public sector pension funds operate.

Nine characteristics stand out. For the most part, the closer one gets to government, the more apparent these characteristics are.

- **A paternalistic "trust me" philosophy**

  The prevailing pension philosophy in government is paternalistic, perhaps unreasonably so in some instances.

  The Government, as employer, has taken to itself the responsibility to make decisions on pension matters – in effect telling its employees, "trust me." Pension contributions for public servants and teachers are invested in non-market government debt. While this is a secure form of investment, no other employer would be permitted to invest its pension fund assets entirely in its own debt which is non-marketable.

An extreme version of this "trust me" philosophy is the view that the best approach would be for government to promise its employees a pension payable from general tax revenues. This would be essentially a pay-as-you-go pension plan.

An advantage of such an approach is that it would be administratively efficient – there would be no pension fund to administer. Its rationale is that the government will not go out of business and therefore its employees can trust a future government to pay the promised pension. Pension liabilities would be paid from current taxes (or government borrowing), not funded in advance by the employer.

Some public sector employers practice the "trust me" philosophy in a different way, by excluding employees from all aspects of pension fund decision-making.

- **Employee Concerns about the Paternalistic Philosophy**

Many public sector employees are dissatisified with the paternalistic or "trust me" philosophy. They are concerned that future generations of taxpayers will not want to pay for the pensions promised and that future governments will respond by retroactively changing the pension deal.

The dramatic demographic shifts expected to occur in the next 20 to 30 years give these concerns some foundation.

There is an understandably close relationship in the minds of some public employees between tangible assets and confidence that their pensions will be paid.

- **Employees Demanding More Say**

Public sector employees are demanding better, more understandable information about the status of their pensions, including information about how the assets of "their" pension funds are invested. They are demanding changes in how their pension deals are implemented and changed and they want to play a role in that process.

- **Blurring of Roles and Responsibilities**

Allied to the paternalistic philosophy is a blurring of the roles and responsibilities of government,[1] with a resulting reduction of accountability and protection of the taxpayer's interest. This blurring of roles is most apparent in the tendency of ministries to assume a policy advisory role in pension matters and to ignore or downplay their employer responsibilities. For example, both the Ministry of Education and the Human Resources Secretariat of Management Board declined invitations to submit a brief to the Task Force.

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[1] See Appendix G for a review of *The Many Roles of Government*.

- **Lack of a total compensation context**

  The Government increasingly wants to compare pension benefits provided to specific groups of public sector employees. There is a concern that the pension benefits of one group will set a precedent for others.

  In making these comparisons, there is little reference to the total compensation being paid to the particular group of employees, to the circumstances of the particular job market or to the trade-offs which employees are or were willing to make among salary, indirect compensation and deferred compensation. In our view, the focus on pension benefits to the exclusion of these other factors is inappropriate.

- **Lack of a Bottom Line Discipline**

  By its nature, the public sector does not have the discipline of a profit and loss accounting system. As well, many public sector functions are considered to be essential services. The lack of a bottom line discipline, and the perception that many government services must not be interrupted, makes it difficult to negotiate employee compensation in a truly competitive marketplace environment.

  Some people believe that the taxpayer pays a higher price than necessary for pensions because of this lack of a bottom line discipline.

- **Unrealistic Expectations**

  Employee representatives tend to have unrealistic expectations, particularly about who should own and control the assets of defined benefit plans. Too little weight is given to the relationship between the liability for wrong decisions and the question of who should control pension fund decision-making. As well, there often appears to be a difference of view between individual plan members and the leadership of their unions or professional associations with respect to whether plan members should control pension fund decision-making.

  On the employer side, there is often an equally unrealistic belief that employees have no business being involved in pension fund decision-making, particularly investment management and investment policy.

- **Diversity of Pension Arrangements**

  We have been impressed with the diverse public sector plans which have evolved and are managed in Ontario. This diversity is healthy.

- **Good Investment Management**

  The investment performance of public sector pension funds investing in market investments is at least as good as the performance of private sector pension funds.

Consequences of our Recommendations

Our recommendations are designed:

- to bring a more market-oriented, less paternalistic philosophy to public sector pensions
- to segregate more clearly pension fund assets from general government finances where this is not now the case
- to emphasize total compensation rather than the size of particular pension benefits
- to clarify government roles and responsibilities with respect to public sector pension plans and pension funds
- to put employees' and employers' expectations into better perspective so that they can be assessed
- to encourage appropriate plan member involvement in pension fund decision-making
- to ensure that the taxpayer's interest is recognized and acted upon
- to retain diversity in pension fund investment management.

SECTION II

A Prospective View

Change is inevitable. While the precise way pensions will change is impossible to predict, it is possible to identify some trends which will likely influence the nature of public sector pensions in Canada in the future.

This section looks briefly at various forms of post-retirement income available to Canadians today and at some trends which could affect public sector pensions in the future.

Post Retirement Income

The Royal Commission on the Status of Pensions in Ontario identified in 1980 a variety of retirement income schemes available to many Canadians. Figure 16.1 is based on the Royal Commission's work:

Retirement Income Schemes Available to Canadians

Sources of Retirement Income	Gross Income Replacement Levels (per cent of average industrial wage: AIW)	Retirement Age	Indexing	Funding	Investment
Occupational Pension Plans	70% maximum of pre-retirement earnings. May or may not be integrated with CPP	As per plan: option from age 60, actuarially reduced	Varies	Most fully funded	Usually employer controlled
Canada Pension Plan	20-25%	65	Fully to preretirement; to CPI post-retirement[2]	Pay/Go[1]	Provincial Investments
Old Age Security	10-15%	65	Fully to CPI[2]	Pay/Go[1]	None
Guaranteed Minimum Income (GIS + GAINS)		65	Fully to CPI[2]	Pay/Go[1]	None
RRSP	Maximum Contributions in 1987: $7500 if no pension plan; $3500 if plan member, minus any employee contributions	60-71	No	Fully Funded	Private Control

[1] Pay/Go = Pay-as-you-go i.e. to pay the pension obligation out of current income rather than pre-funding the pension obligation

[2] CPI = Consumer Price Index, published by Statistics Canada

FIGURE 16.1

Of the above types of retirement income, we concentrated in this report on public sector occupational pension plans and the Canada Pension Plan (CPP).

For some employees, occupational pension plans and the CPP will constitute by far the largest percentage of all retirement income in terms of the replacement of pre-retirement income (as much as 70 per cent). About 55 per cent of Canadian employees are presently not part of an occupational pension plan.

Occupational pension plans are not universally accepted as the best way of providing post-retirement income to employees. Some believe that lower and middle income Canadians are better served by an expansion of tax-based, public pension plans, such as the Old Age Security (OAS), Guaranteed Income Supplement (GIS) and the CPP.

That issue has been debated before and likely will be debated again. We have assumed that occupational pension plans are here to stay, particularly in the public sector, and that improvements in such plans are well worthwhile.

Some Trends

The Task Force has identified three trends which could influence the way we look at public sector pensions in the future:[2]

- demographic
- economic
- social and cultural

Each of these is discussed briefly below.

Demographic Trends

The key trend which will influence pensions and the provision of post-retirement income is the progression of the post-war "baby boom." The baby boom generation is now almost all of working age. Of those now over 25, only about one in six is over the age of 65. This is one of the lowest proportions in any of the developed economies of the world.

In terms of pension costs, this age structure means that there are many people contributing and relatively few retired. Pension plans which are operated on a pay-as-you-go basis currently have relatively low contribution rates.

As the baby boom generation ages, the relative proportions will change dramatically. By 2010, more than one in five will be over age 65. And by 2030, the ratio could be as high as one in three.[3]

This shift – a doubling within 40 years of the number of people over 65 as a proportion of those over 25 – will have a dramatic effect on the costs of pay-as-you-go pension plans. For example, a recently approved schedule for CPP contribution rates provides for increases from 3.6 per cent of salary (up to the year's maximum pensionable earnings) in 1986, to 7.6 per cent in 2011. Further increases are expected after 2011.

Figure 16.2 shows that the combined employer and public servant contribution rate for CPP, PSSF and SAF will increase from 14 per cent of public servants' salaries in 1986 to at least 20 per cent by 2011. This assumes PSSAF contribution rates of 1 per cent each for the employer and employee through 1987, 1.5 per cent from 1988 through 1992, and 2 per cent thereafter. These increases are just enough to keep the PSSAF with a positive cash flow during that period.

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[2] See unpublished Background Paper #1,*Trends in Pensions and Post Retirement Income,* by David Slater. This Background Paper focuses on the first three trends listed, drawing together information from several sources.

[3] Hence the title of the Economic Council of Canada's report, *One in Three,* Economic Council of Canada, 1976.

Cumulative Employer and Public Servant Pension and CPP Contributions for the Period 1986-2011

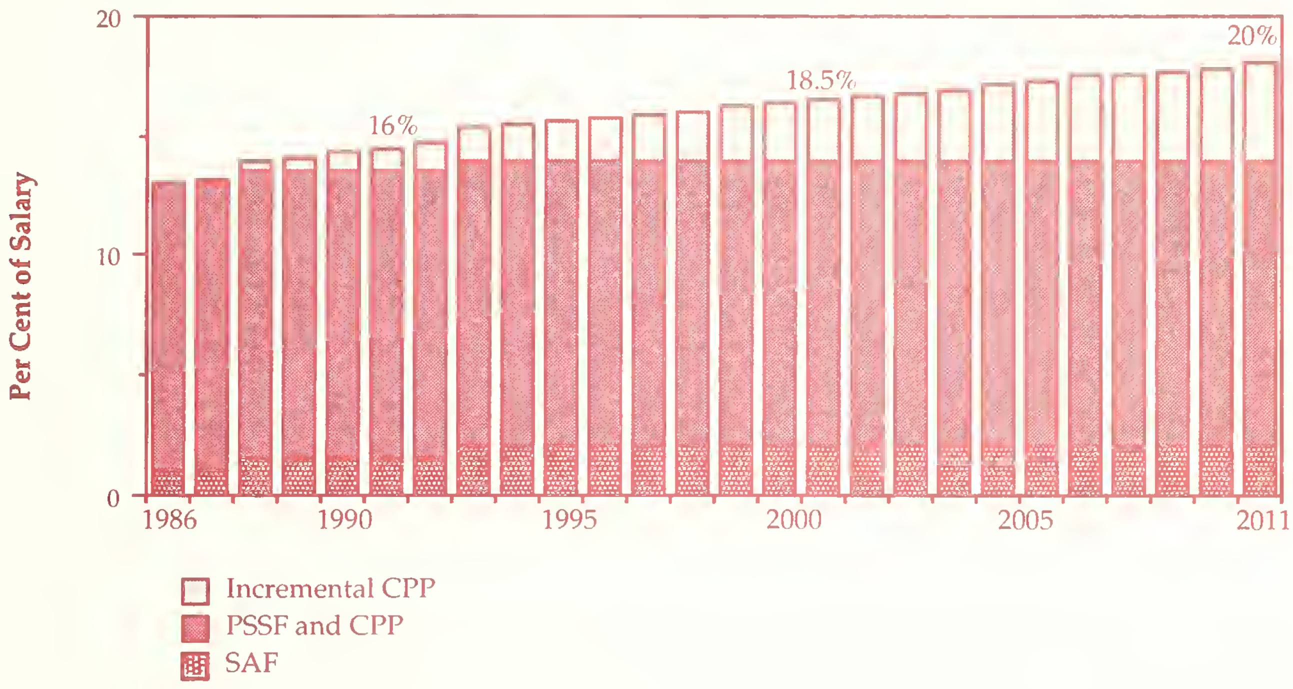

FIGURE 16.2

The contribution increases shown in Figure 16.2 do not reflect possible additional contribution rate changes. For example, pension benefit improvements for public servants and a lengthening life span may result in higher PSSF contribution rates. And, if it is decided that current public servants and taxpayers should pay a larger portion or all of the cost of inflation indexation, a further increase in the combined SAF contribution rates would be necessary.

The escalation of pension costs will be only one of many impacts of the demographic transformation. For example, government expenditures in fields relating to the elderly, such as health and social services, will increase greatly. Overall, those over 65 will be drawing on the accumulated wealth of an economy which will have proportionately fewer working people.

The capital invested in the economy over the next three or four decades, in large part through pension funds and other forms of savings, clearly will be a major factor in the capability of the economy to meet such demands.

Because occupational pension plans are required by law to be fully funded, the effect of this demographic shift on contribution rates for such plans will be much less pronounced. But the financial pressures of government programs for the elderly, plus the rising cost of pay-as-you-go pension plans, reinforce the conclusion that a separation of public sector pension funds from government finances is necessary.

A second important demographic trend is the increased participation of women in the labour force. Between 1963 and 1983, the proportion of women aged 25 to 54 in the labour force doubled, from one-third to two-thirds.

Traditionally, pension plans have not provided benefits in respect of part-time employment or made sufficient allowances for breaks in women's careers during child-rearing years. Both concerns are addressed (at least in part) in new pension legislation, and continued pressure for even broader coverage is certain.

Such expanded coverage, along with benefit improvements provided to all plan members (eg. mandatory inflation protection), will further increase pension costs, both to employers and to plan members.

Economic Trends

Recent forecasts have been moderately optimistic about Canada's economic prospects.[4] Nevertheless, there are a number of considerations which can affect pension programs:

- Technological change, for example, is essential to continued economic growth. But, along the way, significant shifts in the use of capital and in the use of labour will occur. Clearly, this will involve major changes in jobs and restructuring of firms, with attendant effects on pension plans. In turn, this will lead pension fund investment managers to look for the so-called "winners" – those industries or regions with long-term growth prospects – with less investment going to declining industries and regions with weak economies. There likely will be fewer impacts in the public sector but it is by no means immune.
- A second economic trend is the increasing share of total savings provided by pension savings (including RRSPs).[5] The availability of such savings supports new investment and economic growth. In turn, this provides the asset base from which pensions can be paid. Over time, the pension benefits paid out will also increase. This relationship underlines the importance of investing pension funds in market investments.
- Third, growth in employment and new economic opportunities will be based to a large extent in small to medium-sized businesses. These will be attractive prospects for pension fund investments. To the extent this investment does not occur, both the economy and the beneficiaries of pension funds will suffer. The large public sector funds which are in market investments already have recognized and acted on this potential.
- A fourth, inter-related set of economic trends is the globalization and deregulation of capital markets and increasing international competition. These changes can affect pension investments in two ways:
  - First, given that the primary objective of pension funds is to provide retirement income security, they should invest wherever there are prospects of high but reasonably secure long-term returns. This is likely to lead to investments in other parts of Canada as well as in various countries around the globe.

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[4] See Macdonald Commission Report (1985), Vol. 2, pages 60-79 and unpublished Background Paper #1, pp. 22, 23.

[5] See Research Report #5. Keith Ambachtsheer, *An Assessment of the Potential Impact of Mandated Inflation Protection in Employment Pension Plans on Canada's Capital Markets*, Draft Report to the Ontario Task Force on Inflation Protection for Employment Pension Plans, August 1987.

- Second, the accompanying deregulation trend should result in a gradual lessening of investment restrictions on both domestic and global investments by pension funds.

- A fifth trend is the likely continuance of relatively low but persistent (4 per cent or more) inflation. This is forecast to result in long term nominal interest rates around 9 per cent – quite high by historical standards. While this can provide larger nominal investment income for pension funds, inflation cuts into the real level of pensions. And high nominal interest rates can dampen economic growth, restricting the real economic wealth underlying pensions.

Social and Cultural Trends

For a variety of reasons, significant changes are occurring in contemporary society. These changes involve shifts in values, behaviour, technology, communications, social structures and the economy. Collectively they have been characterized as "post-industrial society" or "the third wave" – signifying a dramatic departure from the past.

Analysis of such changes is well beyond the scope of this Section. But, given the long-term nature of pension obligations, we can at least note some of the potential implications of social and cultural change for the pension system.

Diversity vs uniformity

There is an ongoing conflict between pressures for uniformity and conformity on one hand, and for diversity on the other. For the pension system, for example, this conflict is reflected in:

- The move towards greater choice in benefits within individual plans (e.g. the "cafeteria approach"), at the same time as new standards are imposed across the pension system (e.g. mandatory inflation protection). This can be seen as a conflict between the diversity of the marketplace and the desire for a minimum uniformity of pension benefits.

- The move toward a supposedly less restrictive prudent person test for pension fund investments and the retention of quantity and quality tests on investments.

- Increased career mobility, both as a matter of choice and as a matter of necessity when employers restructure or go out of business. This leads to expectations for improved pension portability.

The long term trend appears to be to provide more diversity, while strengthening basic protections or requirements at minimum levels.

Bigger vs smaller

The advantages of economies of scale and the economic strength of concentrations of capital have led to bigness – in institutions, corporations, cities, buildings and organizations. Evidence of this trend is found in corporate takeovers and in the emergence of large pension and other investment funds.

Set against this trend is the vitality and flexibility of small units, in the form of businesses, problem-solving groups and the like. It is widely accepted that most

new job creation occurs in smaller enterprises. And the focus on "intrapreneurship" within large corporations reflects the same theme.

The economies of scale associated with large pension plans and investment funds are embodied in OMERS. The flexibility of small units is reflected in the many small plans also evident in our analysis. The desire for flexibility is reflected, for example, in some criticisms of OMERS as too rigid, too out of touch with individual employers and members.

For the future, can intrapreneurship within large plans be the way to achieve flexibility? Or will the pressure to break up large pension institutions carry the day?

Acceleration of change

Change in all aspects of our lives is accelerating. Pension systems which were put in place 20 to 40 or more years ago cannot be expected to satisfy all the needs of the future without significant change. Yet, given that employees plan for retirement many years ahead, there are dangers in changing pension arrangements too drastically over a short period. In this context, pension issues are likely to be a focus for conflict, reflecting both pressures for change and the built-in constraints of pension institutions and legislation.

Leveling of structures/greater involvement

Today's society is much less willing than previous generations were to accept authority uncritically. People are less willing to "buy in" to decisions which are important to them if they have not been involved in the decision-making process. And there is growing recognition that decisions which are made following a process which involves those who are affected usually are better decisions.

The pension system traditionally has been paternalistic; employers have made decisions on behalf of plan members. This will be less prevalent in the pension environment of the future. Employees and retirees will be involved more in the pension deal in general, including in pension fund investments.

Legislative and regulatory constraints

The continued pressure for minimum standards, noted earlier, is leading to more stringent requirements for pension plans, including earlier vesting, portability, inflation protection and clear and comprehensive documentation.

The conflicting pressures for diversity and flexibility, and the increasingly competitive economic climate, may lead employers to shift from defined benefit to defined contribution plans (which are less complex to administer) or to non-pension plan arrangements such as deferred profit sharing or RRSPs.

Relevance of Trends to Pensions and Post-Retirement Income Security

Predictable changes in demographic structure over the next few decades will lead to a heightening public awareness of and focus on issues relating to the provision of post-retirement income.

Along with the OAS and CPP, occupational pension plans offer the prospect of reasonable post-retirement income (relative to employment income) for those who

are covered. Members of Ontario's public sector pension plans typically anticipate that their pension arrangements will provide reasonable post-retirement income.

The trends we have identified, for the most part, do not threaten this post-retirement income security. Rather, they suggest greater diversity in options, flexibility in coverage, portability of pension entitlements and responsiveness to changing needs. They indicate that retirement savings will be of growing significance in the capital markets and in the promotion of economic growth. And they underline the need for more flexible pension institutions which will be capable of evolving to meet changing needs.

The dramatic demographic shift towards an older population will contribute to significant economic changes. In 30 or 40 years, the elderly population will be drawing on the accumulated wealth – both personal and social – built up in the intervening decades. Whether that wealth will be sufficient to meet expectations will depend in part on how wisely investments are made today.

The analysis and recommendations in this report have been developed with an eye on the future. While of necessity not the last word, our report helps to chart a course for those who have responsibility for the investment of Ontario's public sector pension funds.

Implementation of the Task Force's recommendations will give the public sector pension system greater flexibility and thereby enable it to adapt more quickly and with less stress to the needs of the times. This, in itself, is a worthwhile goal.

LIST OF APPENDICES

APPENDIX A

TERMS OF REFERENCE (Order-in-Council O.C. 2530/86)
September 24, 1986

WHEREAS it is the desire of the Government of the Province of Ontario to ensure that the investment of public sector pension plans meets the needs and circumstances of today's financial environment, best serves the pension beneficiaries and advances the province's economic development;

AND WHEREAS the Government of Ontario believes it is in the public interest to establish a Task Force to study and report upon the investment of public sector pension funds;

THEREFORE a Task Force be established pursuant to the Public Inquiries Act:

a) to examine public sector pension funds in Ontario:

   i) to determine whether the current methods and approaches to the investment of such funds in Ontario most appropriately meets the needs of the present and future pension beneficiaries in today's economic and financial environment;

   ii) to determine whether economic development in Ontario could be increased through changes to the way public sector pension funds are invested;

   iii) to identify options available to the government;

b) to review the experience and practices of other jurisdictions with respect to the investment of public sector pension funds;

c) to recommend changes, as appropriate, with special emphasis on the major pension pools, including the Teachers' Superannuation Fund, the Public Service Superannuation Fund, the Superannuation Adjustment Fund, the Hospitals of Ontario Pension Fund (H.O.O.P.), the Workers' Compensation Board Pension Fund, Ontario Municipal Employees Retirement System (O.M.E.R.S.) and the Ontario Hydro Pension Fund;

d) to examine the way in which Canada Pension Plan funds are utilized and invested;

And that all government ministries, boards, agencies and commissions assist the Task Force to the fullest extent in order that it may carry out its duties and function;

And that the Task Force have the authority to engage expert technical and legal advisors, investigators and other staff as it deems proper at rates of remuneration and reimbursement as approved by the Management Board of Cabinet;

And that the Task Force be established for a period of one year, effective from the 24th day of September, 1986, to the 23rd day of September, 1987.

APPENDIX B

DEFINITION OF A PUBLIC SECTOR PENSION FUND

McMILLAN, BINCH

BARRISTERS & SOLICITORS

P.O. BOX 38
SOUTH TOWER
ROYAL BANK PLAZA
TORONTO, ONTARIO
M5J 2J7

TELEPHONE (416) 865-7111
TELEX NO. 06-22317
CABLE ADDRESS "WARDRITE"
TELECOPIER NO. (416) 865-7048

June 10, 1987

Mr. Malcolm Rowan
Chairman
Task Force on Investment of
Public Sector Pension Funds
5th Floor
101 Bloor Street West
Toronto, Ontario
M5S 1P7

Dear Mr. Rowan:

You have asked us to assist you in developing a definition of "public sector pension plan" for the purpose of the Task Force's review of the investment of public sector pension funds.

The terms of reference of the Task Force do not define "public sector". In addition, there is no precise technical definition of "public sector" either in the Interpretation Act, or in more specific legislation which would permit a clear and automatic differentiation between public and private sector pension plans.

Whether a pension plan is a public sector pension plan will depend upon whether the sponsor of the plan can be properly characterized as part of the "public sector". There are a number of tests that could be applied to plan sponsors in order to fashion a stipulative definition for your purposes:

1. **Mandate:** the nature of the authority exercised or service provided by a plan sponsor and its relationship to core governmental responsibilities or functions.

2. **Ownership:** the extent to which a plan sponsor is wholly owned by the Crown. An additional relevant factor would be the right to nominate directors to the board of a plan sponsor.

3. **Funding**: the sources of funds of a plan sponsor. Does it have revenue sources independent of the Consolidated Revenue Fund.

4. **Autonomy**: the degree of ministerial direction or operational autonomy of a plan sponsor.

We are most attracted to the second and third of these tests, namely the ownership (including control of the board) and funding criteria.

The Ontario Legislature has addressed the question of definition of the public sector in a number of recent provincial statutes. The statutes each employ variations of the ownership and funding tests set out above. A fairly standard definition has been arrived at and has been employed in the following Acts:

Inflation Restraint Act S.O. 1982, c. 55

Public Sector Prices and Compensation Review Act S.O. 1983, c. 70

Pay Equity Bill 154, 1986

The stipulative definition that has developed in these Acts is a combination of an eight-part functional test, coupled with a residual schedule. The separate parts of the definitional test found in the Public Sector Prices and Compensation Review Act, 1983 are set out below:

1. **THE CORE PUBLIC SECTOR**

This is defined as:

"The Crown in Right of Ontario, every agency thereof and every authority, board, commission, corporation, office or organization of persons, a majority of whose directors, members or officers are appointed or chosen by or under the authority of the Lieutenant Governor in Council or a member of the Executive Council".

2. **MUNICIPALITIES**

These are defined as:

"The corporation of every municipality in Ontario, every local board as defined by the Municipal Affairs Act, and every authority, board, commission, corporation, office or organization of persons whose members or officers are appointed or chosen by or under the authority of the Council of the corporation of a municipality in Ontario".

3. **SCHOOL BOARDS, UNIVERSITIES AND COLLEGES**

These are defined as:

"Every board as defined in the Education Act, and every college, university or post-secondary school educational institution in Ontario, the majority of the capital or annual operating funds of which are received from the Crown".

4. **HOSPITALS**

These are defined as:

"Every hospital listed in the Schedule to Regulation 863 of Revised Regulations of Ontario, 1980 made under the Public Hospitals Act, every private hospital operated under the authority of a licence issued under the Private Hospitals Act, every hospital established or approved by the Lieutenant Governor in Council as a community psychiatric hospital under the Community Psychiatric Hospitals Act and every sanitarium licensed by the Lieutenant Governor in Council under the Private Sanitaria Act".

5. **CROWN-OWNED CORPORATIONS**

These are defined as:

"Every corporation with share capital, at least 90% of the issued shares of which are beneficially held by or for an employer [who is the provincial crown or agencies thereof, a municipal organization, a school board, a college or university, or a hospital], and every wholly-owned subsidiary thereof".

6. **NON-SHARE CAPITAL CORPORATIONS OWNED BY THE CROWN**

These are defined as:

"Every corporation without share capital, the majority of whose members or officers are members of, or are appointed or chosen by or under the authority of, an employer or employers [who is the provincial crown or agencies thereof, a municipal organization, a school board, a college or university, or a hospital], and every wholly-owned subsidiary thereof".

7. **BOARDS OF HEALTH**

These are defined as:

"Every local board of health of a Municipality or of a health unit under the Public Health Act and every board of health under an Act of the Legislature that establishes or continues a regional municipality".

8. **LEGISLATURE AND OTHER INSTITUTIONS INDEPENDENT OF GOVERNMENT**

These are defined as:

"The Office of the Lieutenant Governor of Ontario, the Office of the Assembly, members of the Assembly, the Office of the Ombudsman and the Provincial Auditor".

9. SCHEDULED ORGANIZATIONS

These are defined as:

"Any authority, board, commission, corporation, office, person or organization of persons or any class of authorities, boards, commissions, corporations, offices, persons or organizations of persons" set out in an appendix to the statute. Most of these are specifically named institutions, but some clauses of the schedule incorporate other tests. For example, if a non-governmental organization receives government funding to provide community mental health services, it is included in the Schedule.

We believe that the approach taken by the Legislature in the Acts mentioned above is, in large part, appropriate for the purposes of the Task Force. That is, pension plans sponsored by entities that are described in the eight functional categories may properly be described as "public section pension plans".

The question arises whether it is appropriate to consider as public section plans, the pension plans sponsored by organizations that fall within the ninth category "Scheduled Organizations" set out above. These are only included in the public sector definition by virtue of the schedules to the Acts. For the most part, scheduled organizations are non-government organizations or private enterprises. The scheduled organizations often receive some government funding for their projects or operations. Because of the element of government financing, the public has an interest in ensuring that the scheduled organizations are subject to the same wage and price restraints or the same rules regarding pay equity as organizations in the core public sector. It is this public interest that dictates the inclusion of the scheduled organization in the definition of the public sector for the purposes of wage and price review or pay equity legislation.

The policy objectives of the Task Force relate to its mandate to consider what special rules, if any, should govern the investment of the assets of pension plans covering public sector employees. The public interest that is served by subjecting the scheduled organizations to wage and price control or pay equity legislation does not apply with equal force to the definition of public sector for the purposes of the Task Force. In our view, it is reasonable for the Task Force to exclude the pension plans sponsored by scheduled organizations from its definition of "public sector pension plans".

Yours very truly,

McMillan, Binch

APPENDIX C

CATALOGUE OF ONTARIO'S PUBLIC SECTOR PENSION FUNDS LISTED IN ORDER OF ASSET SIZE

	Ontario Public Sector Pension Funds	Type[1]	Sector	Status[2]	Assets[3] ($000)	Employees[6]
1	Teachers' Superannuation Fund (TSF)	D B	Education	Open	10,104,000	138,620
2	Ontario Municipal Employees Retirement System (OMERS)	D B	Municipal	Open	7,322,976[4]	135,098
3	Public Service Superannuation Fund (PSSF)	D B	Core Gov't	Open	4,030,600	77,300
4	Hospitals of Ontario Pension Plan (HOOPP)	D B	Health	Open	3,680,482	71,325
5	Ontario Hydro (HYDRO)	D B	Core Gov't	Open	3,278,546	23,041
6	Superannuation Adjustment Fund (SAF)	D B	Core Gov't	Open	1,300,100	(7)
7	Colleges of Applied Arts and Technology (CAATS)	D B	Education	Open	858,819	14,413
8	University of Toronto	D B	Education	Open	717,423	6,085
9	Toronto Transit Commission (TTC)	C	Municipal	Open	648,728	9,400
10	Metro Toronto Employees	D B	Municipal	Closed	479,853	2,800
11	Metro Toronto Police	D B	Municipal	Closed	419,761	1,563
12	Toronto Civic Employees	D B	Municipal	Closed	310,114	1,120
13	Queen's University	C	Education	Open	285,969	2,201
14	McMaster University/Salaried Employees	D B	Education	Open	270,024	2,387
15	University of Ottawa	D B	Education	Open	254,697	3,425
16	Workers' Compensation Board (WCB)	D B	Core Gov't	Open	253,924	3,535
17	York University	C	Education	Open	237,808	2,500
18	University of Waterloo	D B	Education	Open	229,032	2,179
19	University of Western Ontario/Academic	DC	Education	Open	191,721	1,387
20	Toronto Fire Department	D B	Municipal	Closed	181,971	648
21	Ontario Northland Transportation	D B	Core Gov't	Open	172,232	1,416
22	Carleton University	C	Education	Open	167,339	1,474
23	City of Ottawa	D B	Municipal	Closed	161,503	600
24	Sisters of St Joseph's	D B	Health	Open	157,175	3,028
25	University of Guelph/Prof Staff	D B	Education	Open	150,920	1,094
26	Hospital for Sick Children	D B	Health	Open	146,920	2,938
27	Hamilton Municipal	D B	Municipal	Closed	88,926	110
28	Ryerson Polytechnical Institute (RYERSON)	D B	Education	Open	84,304	1,184
29	University of Western Ont/Admin	DC	Education	Open	81,119	2,493
30	University of Windsor/Faculty	C	Education	Open	70,739	539
31	Kitchener-Waterloo Hospital	D B	Health	Open	53,255	1,159
32	University of Guelph/Retirement Plan	D B	Education	Open	49,588	1,137
33	Hamilton Street Railway Company	D B	Municipal	Open	49,218	925
34	Wilfrid Laurier University	C	Education	Open	49,124	563
35	Municipal Hydro Electric Group	D B	Municipal	Closed	45,653	3,082
36	City of York	D B	Municipal	Closed	40,241	175
37	Brock University	C	Education	Open	38,960	512
38	Lakehead University/Prof. Staff	D B	Education	Open	34,822	309
39	Trent University	D B	Education	Open	34,550	458

40	Ont Institute for Studies in Education (OISE)	C	Education	Open	33,809	426
41	Ont Cancer Institute	C	Health	Open	32,190	463
42	University of Windsor/Admin	DB	Education	Open	31,503	744
43	Laurentian University	C	Education	Open	29,460	479
44	Ont Cancer Treat. & Research Foundation	DB	Health	Open	29,460	469
45	Ont Educational Communications Authority	DB	Core Gov't	Open	23,001	359
46	Royal Ontario Museum	DB	Core Gov't	Open	15,769	500
47	University of Guelph/Non-Prof Staff	DB	Education	Open	15,092	209
48	Sunnybrook Hospital	DB	Health	Closed	14,337	500
49	City of Kitchener-Fire Fighters	DB	Municipal	Closed	12,265	50
50	Ont Research Foundation	DB	Core Gov't	Open	10,949	300
51	Lakehead University/Tech., Cler., Maint.	DC	Education	Open	6,524	228
52	Transit Windsor	DB	Municipal	Open	6,339	240
53	McMaster University/Hourly Employees	DB	Education	Open	5,970	333
54	Ont College of Art	DC	Education	Open	5,434	124
55	London Transit Commission	DB	Municipal	Open	5,423	391
56	Art Gallery of Ontario	DB	Core Gov't	Open	4,199	77
57	University of Western Ont – King's College	DB	Education	Open	2,939	76
58	Ont Stock Yards Board	DB	Core Gov't	Open	2,853	47
59	City of North Bay	DC	Municipal	Closed	2,777	20
60	Laurentian University – Algoma U College	DB	Education	Open	2,424	30
61	Laurentian University – Nipissing University College	DC	Education	Open	2,053	44
62	Ont Educational Communications Authority/Exec.	DB	Core Gov't	Open	1,448	5
63	Town of Tillsonburg	DC	Municipal	Closed	1,043	12
64	Hamilton Region Conservation Authority	DC	Municipal	Open	1,034	43
65	University of Western Ont – King's College	DC	Education	Open	914	42
66	University of Western Ont – Brescia College	DC	Education	Open	800	36
67	Metro Toronto Convention Centre	DB	Core Gov't	Open	703	86
68	Halton Region Conservation Authority	DB	Municipal	Open	612	43
69	Ont Centre for Advanced Manufacturing	DC	Core Gov't	Open	554	9
70	Town of Gananoque	DC	Municipal	Closed	538	5
71	Lakehead Board of Education	DC	Education	Closed	462	9
72	Ont Centre for Farm Machinery & Food Proc.	DC	Core Gov't	Open	351	39
73	Fort Frances/Rainy River Bd of Ed	DC	Education	Closed	236	5
74	Otonabee Region Conservation Authority	DC	Municipal	Open	210	9
75	Kenora Board of Education	DC	Education	Closed	200	2
76	Ont Centre for Automotive Parts	DC	Core Gov't	Open	193	34
77	Nickel District Conservation Authority	DC	Municipal	Open	186	7
78	Manitoulin-Sudbury District Health Council	C	Health	Open	138	3
79	Ont Library Service – Nipigon	DC	Municipal	Open	120	11
80	Township of Kingston	DC	Municipal	Closed	87	2
81	Southwest Middlesex Health Centre	DC	Municipal	Open	77	13
82	Ont Centre for Resource Machinery Tech	DC	Core Gov't	Open	74	10
83	Long Point Region Conservation Authority	DC	Municipal	Closed	54	1
84	Peel District Health Council	DC	Health	Closed	49	2

85	Durham Region District Health Council	DC	Health	Closed	32	2
86	Kingston District Health Council	DC	Health	Closed	12	1
					37,038,033[5]	528,763

Public Sector Pension Plans Which Purchase Annuities and Do Not Build a Fund

1	University of Western Ont – Huron College	DC	Education	Open	N/A	52
2	Ont Centre for Micro Electronics	DC	Core Gov't	Open	N/A	41
3	City of Oshawa	DC	Municipal	Closed	N/A	17
4	Guelph Transportation Commission	DC	Municipal	Closed	N/A	9
5	Township of Lochiel	DC	Municipal	Closed	N/A	8
6	Bd combined R.C.S.S. Chapleau	DC	Education	Closed	N/A	7
7	Township of Bangor Wicklow & McClure	DC	Municipal	Closed	N/A	7
8	Township of Euphenia	DC	Municipal	Open	N/A	4
9	Victoria County Board of Education	DC	Education	Closed	N/A	3
10	Township of Dungannon	DC	Municipal	Open	N/A	3
11	North York Board of Education	DC	Education	Closed	N/A	2
12	Cochrane District Health Council	DC	Health	Closed	N/A	1
13	Township of Tuckersmith	DC	Municipal	Open	N/A	1
						155

Notes:

(1) DB: Defined Benefit
DC: Defined Contribution
C: Combined

(2) Open: All Employees Contribute To The Fund
Closed: New Members Contribute To OMERS or HOOPP Funds

(3) Market Value as at December 31, 1986. Book value for the TSF, PSSF, SAF. Book value for that portion of OMERS, CAATS and RYERSON, which is invested in non-market government debt.

(4) Does not include assets of CAATS and RYERSON, both funds managed by OMERS

(5) Total assets amount to $39.0 billion if imputed market value rather than book value is considered for the funds in (3) which invest all or part of their assets in non-market government debt

(6) Employee data as of December 31, 1985

(7) Contributors are the same as in the TSF, PSSF and RYERSON funds

APPENDIX D

CAPITAL MARKET RETURNS, PUBLIC SECTOR PENSION FUNDS AND ASSET MIX POLICY

By Keith P. Ambachtsheer, Keith P. Ambachtsheer & Associates Inc.

Introduction

This paper provides a number of comparisons between a sample of public sector pension funds' rates of return, and the rates of return of a number of indexes and of Canadian pension funds in general. It also provides a basis for assessing differences in rates of return given the divergent asset mixes of pension funds.

Study Summary and Conclusions

1. Stocks have outperformed bonds by an average 5% per year since the mid-1920's in Canada, with the former earning 10% and the latter 5% vs. a 3% long term inflation rate.

2. Both asset classes have exhibited significant return variability during the last 60 years. Four year real returns have been as high as +32% per annum and as low as -17% per annum for stocks. The comparable range for bonds was +18% to -11%.

3. The typical pension fund asset mix during the last 10 years was close to 50% equity investments/50% debt investments. Most of the equity was in Canadian common stocks, most of the debt was in high-quality long term bonds. The typical pension fund earned 14.1% per year during the 10 years ending 1985. The CPI advanced 7.8% per year during this period, permitting the typical fund to earn over 6% per annum in real terms. However, 3% was the typical average real return realization for the last 25 years. By contrast, a 100% long bond policy would have earned about 1% in real terms over the last 25 years.

4. Public sector pension funds which had discretion in choosing their own asset mix had virtually the same '50-50' average asset mix as the median pension fund in a large comparative measurement service sample. The median return in the 21 public sector pension fund sample over the five year 1982-1985 period was 15.1% per annum.

   This compares favorably with the 14.8% and 14.4% median returns in two comparative measurement service samples. Because of sharply falling long term bond yields, a 100% long bond portfolio would have returned 17.3% over this five year period. Inflation averaged 6.8% per year.

5. Further analysis of the 21 public sector pension fund sample found there was no correlation between the 5 year performance of the 21 funds and their dollar size.

6. While the study of historical capital markets relationships can provide important insights, it is not a substitute for the prospective judgements fund fiduciaries must make on an ongoing basis.

Canadian Capital Market Returns

The Canadian Institute of Actuaries maintains a data base on Canadian capital market returns going back to 1924. PFA (now SEI) maintains a data base on a large number of Canadian pension funds going back more than 25 years. The following are some of the key results for various time frames:

Annual Compound Rates of Return to the End of 1985
(Return standard deviation provided in brackets underneath.)

	TSE Stocks	Canada Bonds	Mortgages	T-Bills	Median Fund	CPI
Last 61 years	10.5%	4.8%	N/A	N/A	N/A	3.3%
	(19.9%)	(8.3%)				(4.7%)
Last 25 years	11.1%	6.6%	9.0%	7.8%	8.7%	5.8%
	(17.1%)	(10.9%)	(6.7%)	(4.3%)	(8.4%)	(3.6%)
Last 10 years	16.8%	10.9%	13.4%	11.9%	14.1%	7.8%
	(17.7%)	(14.6%)	(7.0%)	(3.7%)	(6.6%)	(3.0%)
Last 5 years	9.4%	17.3%	17.1%	13.4%	14.7%	6.8%
	(19.1%)	(17.5%)	(7.7%)	(4.3%)	(9.4%)	(3.7%)
Best 4 year	32.6%	18.1%	13.6%	6.9%	12.9%	–
REAL return (ending)	(1928)	(1985)	(1984)	(1984)	(1985)	–
Worst 4 year	-16.8%	-10.9%	-2.7%	-6.1%	-6.0%	–
REAL return (ending)	(1932)	(1981)	(1981)	(1951)	(1976)	–

Observations

1. The best number we have for long term real returns on common stocks is about 7%. But variability around that long term average has been dramatic. Most dramatic were the successive 4 year periods 1925-1928, 1929-1932, and 1933-1936 where annualized four year real returns swung from +32.6% to 16.8% to +31.2%. The best and worst post-WW II four year periods were 1948-1951 (+21.7%) and 1973-1976 (-8.3%).
2. The 1.5% long term real return on long Canada bonds reflects a continual rise of long bond yields over most of the last 60 years. The promised real yield has been more like 2%. The reversal of this long term trend during the last 4 years shows up as an annualized 18.1% real rate of return from 1982-1985, the best 4 year real return experience over the entire period. It followed the worst 4 year period (1978-1981 at -10.9% per annum).
3. The median Canadian pension fund earned about a 3% real rate of return over the last 25 years. The annualized 12.9% earned over the 1982-1985 period is the best 4 year experience recorded to date.

Canadian Pension Fund Returns and Asset Mix

The PFA/SEI sample provides data on asset mix as well as on returns. Below is a matrix of data on both median asset mix weights and median fund returns over the last 10 years. In addition, the average asset mix weights of a sample of 21 public sector pension funds where the trustees have asset mix discretion (identified later in this Study) at the end of 1985 is also shown:

SEI/PFA Median Asset Mix Weights

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	21 funds 1985
% Cdn Stocks	35	31	31	31	32	30	29	38	34	36	35
% Non-Cdn. Stocks	5	4	5	6	8	7	9	9	9	10	9
% Bonds	31	33	31	31	33	35	40	37	40	42	40
% Mortgages	19	20	17	14	10	8	6	4	1	0	4
% Cash	4	6	9	12	10	14	9	6	8	7	9
% Other	(median values zero, but **average** values probably about 4% with most of it in real estate and the rest in venture and oil and gas investments).										

Observations

1. The median fund in the PFA/SEI sample has steadily been 40%-50% invested in equities, with the balance in fixed income. There is some evidence that overall equity exposure has been marginally rising through increased exposure to foreign stocks, and direct investments in real estate, oil and gas, and venture capital.

2. There is also evidence of a shift within the fixed income component of pension funds... away from mortgages into bonds and, to a lesser degree, cash-equivalents. This is at least partially due to the shift of pension fund assets away from trust and insurance companies (with mortgage generation facilities) to investment counsellors (who don't have these facilities).

3. Public sector pension funds, where the trustees have discretion, appear to have asset mix policies indistinguishable from the broad universe of pension funds.

The next table provides the 'returns' side of the picture. The 'Passive Mix' is maintained at 35% TSE300, 10% S&P500, 35% MYW Long Bond Index, 10% MYW Mortgage Index, 10% T-Bills. All returns are pre-management fees. The 'Passive Mix' returns are pre-transaction costs as well.

Annual Returns

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	10 yr
Median Fund	13.0	9.2	13.2	14.8	17.5	1.8	22.1	19.1	8.6	23.5	14.1
Passive Mix	15.3	7.4	13.1	18.4	16.7	-2.1	23.6	21.1	7.5	24.8	14.3
100% Canada Bonds	19.0	6.0	1.3	-2.6	2.1	-3.0	43.0	9.6	15.1	26.7	10.9
CPI	5.8	9.5	8.4	9.8	11.2	12.1	9.3	4.5	.38	4.4	7.8

Observations

1. The actively managed 'Median Fund' and the constant 'Passive Mix' track each other closely on a year by year basis. On a 10 year basis, they produced almost identical investment results.

2. The 100% Canada Bonds strategy produced considerably more volatile year by year results over the 10 year period. On a 10 year basis, the annualized return came in more than 3% below that of the 'Median Fund' and the 'Passive Mix.'

Public Sector and Private Sector Fund Performance

The PFA/SEI sample contains investment results on some 500 Canadian pension funds. In the comparison below, the investment results from 1981-1985 for this sample is compared against a sub-sample of 21 public sector plans whose funds are invested through the capital markets:

		Annualized ROR		
1.	Queen's University	18.4%	->	**5th percentile break**
2.	Ontario Northl. Transp.	17.8%		
3.	Wilfrid Laurier University	17.8%		
4.	Trent University	16.6%		
5.	WCB	16.6%	->	**1st quartile break**
6.	OMERS	16.1%		
7.	Metro Toronto	16.0%		

8.	TTC	15.4%		
9.	Ontario Hydro	15.2%		
10.	University of Toronto	15.1%		
11.	McMaster University	15.1%	->	**median**
12.	Ontario Research Found.	15.0%		
13.	Brock University	14.9%		
14.	Metro Police	14.9%		
15.	O.E.C.A.	14.9%		
16.	University of Waterloo	14.9%	->	**3rd quartile break**
17.	York University	14.6%		
18.	Carleton University	13.9%		
19.	HOOPP	13.4%		
20.	Univ. of Western Ont.	12.5%		
21.	University of Windsor	12.4%	->	**95th percentile break**

The PFA/SEI Measurement Service provides the 5th percentile, 1st quartile, median, 3rd quartile, and 95th percentile breaks for its broadly-based 500 pension fund sample. The COMSTAT Measurement Centre provides data on various types of pooled funds managed by Canadian investment management organizations. These pooled funds tend to be used most frequently by small pension plans.

COMSTAT has a sample of 14 diversified pooled funds (most funds tend to have a single asset class orientation such as stocks, bonds, real estate, etc.). This sample is split into maximum, 1st quartile, median, 3rd quartile, and minimum return breaks. The PFA and COMSTAT breaks for the 1981-1985 period are directly comparable to those developed above:

	SEI/PFA Return Breaks	COMSTAT Return Breaks	21 Public Sector Fund Return Breaks
5th percentile	18.1%	17.8%	18.4%
1st quartile	16.0%	15.2%	16.6%
median	14.8%	14.4%	15.1%
3rd quartile	14.0%	13.1%	14.9%
95th percentile	12.3%	12.6%	12.4%

Observations

1. The dispersion of the three distributions appears to be almost identical, suggesting a range of investment policies within the 21 public sector funds as broadly dispersed as occurs within Canadian pension funds generally.

2. The return distribution of the 21 public sector funds appears to be placed above that of the PFA/SEI and COMSTAT samples. Note almost all five break points for the 21 funds lie above the two comparative sample counterparts. Thus the 21 public sector fund sample has currently not underperformed Canadian pension funds generally during the last 5 years... indeed, it appears there might have been some marginal outperformance.

Public Sector Pension Fund Within-Sample Performance

There was no correlation between the 5 year performance of the 21 public sector pension funds and fund size. This finding confirms the results of other studies which have failed to find any systematic relationship between pension fund performance and pension fund dollar value.

The performance of OMERS, ONTARIO HYDRO, and HOOPP is of special interest. These three funds are self-managed and account for $13 billion of the $16 billion represented in the 21 fund sample. These funds ranked 6th, 9th, and 19th out of 21 for this particular 5 year measurement period, for an average ranking of 11th in a 21 fund sample. This result suggests there was nothing abnormal in the performance of these 3 funds in relation to the other 18.

The Future

While a study of historical return relationships in the capital markets is useful, this does not imply that historical relationships are necessarily the only or even best guide for judging prospective capital markets return relationships.

Making and reviewing such prospective judgements is one of the key ongoing responsibilities of pension fund fiduciaries.

APPENDIX E

LIST OF SUBMITTORS OF BRIEFS TO THE TASK FORCE

Employees/Pensioners

Mrs. G. Faye McCormack
Thunder Bay, Ontario

Mr. David Tovell
Toronto, Ontario

Mr. John B. Glazebrook
London, Ontario

Mr. Stanley Crow
Don Mills, Ontario

Mr. T. F. Rushton
London, Ontario

Mr. and Mrs. D. Whitney
Markham, Ontario

Ms. Freeda M. Knapp
Bowmanville, Ontario

Mr. R. Kenney
Rossport, Ontario

Mr. N. C. Burlock
Guelph, Ontario

Mrs. Catherine M. Campbell
Chatham, Ontario

Mr. T.A. Somerville
Amherstview, Ontario

Mrs. Catherine M. Campbell
Chatham, Ontario

Mr. T. A. Somerville
Amherstview, Ontario

Mr. Gilles Pouliot, MPP
Lake Nipigon Riding
on behalf of the following:

Ms. Shirly Mikus
Terrace Bay, Ontario

Mrs. Reta E. Wylie
Geraldton, Ontario

Mrs. Margaret Marland, MPP
Mississauga South
on behalf of the following:

Mr. J. Finlayson
Mississauga, Ontario

Miss Velma E. Gilbert
Port Credit, Ontario

Mr. V. Collins
Oshawa, Ontario

Mrs. Gertrude M. Scott
Toronto, Ontario

Mr. P. J. Burns
Pickering, Ontario

Mr. D. Bruce Mennie, CLU
Niagara Falls, Ontario

Ms. Marcia A. Redmond
Kitchener, Ontario

Mrs. Marnie Levitt
Ottawa, Ontario

Mr. W. R. Mitchell
North Bay, Ontario

Mrs. Jeanne L. Wellhauser
Arriss, Ontario

Mr. John A. MacGregor
Toronto, Ontario

Mr. Floriant Venne
Sudbury, Ontario

Mr. John A. MacGregor
Toronto, Ontario

Mr. Floriant Venne
Sudbury, Ontario

Mr. W.S. McNay
Mississauga, Ontario

Ms. Jean Johnson
Mississauga, Ontario

Miss Edith Paulsen
Mississauga, Ontario

Mr. John Rahhola
Mississauga, Ontario

Mr. G. Murray Lea
Mississauga, Ontario

Mrs. E.M. Radford
Mississauga, Ontario

Mr. John E. Bailey
Mississauga, Ontario

Ms. Jessie Finlayson
Mississauga, Ontario

Unions and Professional Associations

President, Local 515
Ontario Public Service Employees Union
Toronto, Ontario

Ontario Provincial Police Association
Barrie, Ontario

CUPE 503 Pension Commission
The Ottawa-Carleton Public Employees' Union
Ottawa, Ontario

Ontario Separate School Business Officials' Association
Hamilton, Ontario

Ontario Teachers' Federation
Toronto, Ontario

Ontario Federation of Labour
Don Mills, Ontario

Ontario Secondary School Teachers' Federation
Toronto, Ontario

Canadian Pulp & Paper Association
Montreal, Quebec

President, OPSEU Local 658
Canadore College of Applied Arts and Technology
North Bay, Ontario

Superannuated Teachers of Ontario
Toronto, Ontario

Pension Committee
The Ontario Secondary School Teachers' Federation – District 1
Windsor, Ontario

Ontario Professional Firefighters Association
Toronto, Ontario

Police Association of Ontario
Toronto, Ontario

Ontario Association of School Business Officials
Toronto, Ontario

Ontario English Catholic Teachers' Association
Windsor, Ontario

Advisors/Professional Groups/Service Vendors

Pension Investment Association of Canada
Scarborough, Ontario

Allenvest Group Limited
Toronto, Ontario

Canadian Life and Health Insurance Association Inc.
Toronto, Ontario

Teachers' Money Matters
Thornhill, Ontario

The Canadian Bankers' Association
Toronto, Ontario

Midland Doherty Limited
Public Finance Department
Toronto, Ontario

National Trust
Toronto, Ontario

Burns Fry Limited
Toronto, Ontario

Royal Trust
Toronto, Ontario

The Toronto Society of Financial Analysts
Toronto, Ontario

The Association of Canadian Pensions Management
Toronto, Ontario

Canadian Federation of Independent Business
Willowdale, Ontario

Wood Gundy Inc.
Toronto, Ontario

The Institute of Chartered Accountants of Ontario
Toronto, Ontario

Dominion Securities Inc.
Toronto, Ontario

Canadian Institute of Actuaries
Ottawa, Ontario

Association of Canadian Venture Capital Companies
Edmonton, Alberta

The Ontario Chamber of Commerce
Toronto, Ontario

Sponsors/Administrators

Metropolitan Clerk's Department
Toronto, Ontario

Ontario Municipal Employees Retirement Board
Toronto, Ontario

Teachers' Superannuation Commission
Willowdale, Ontario

Pension Fund Society
Toronto Transit Commission
Toronto, Ontario

Ontario Hospital Association
Don Mills, Ontario

Ontario Council of Regents for Colleges of Applied Arts and Technology
Toronto, Ontario

Ontario Hydro
Toronto, Ontario

Department of the City Clerk
Toronto, Ontario

APPENDIX F

SEMINAR ON THE INVESTMENT OF PUBLIC SECTOR PENSION FUNDS

Niagara Institute, Niagara-on-the-Lake
June 15 – 17, 1987

Seminar Program

Tuesday, June 16

Seminar Overview ~ *K. Ambachtsheer*

Governance Section

Chairman	*J. Solursh*

The Pension Deal

Discussion Leader	*D. Ezra*
Discussants	*R. Baldwin*
	J. Pesando

Public Sector Pension Funds: An Overview ~ *P. Vlahos*

Governance Implications of the Different Pension Deals

Discussion Leader	*W. Macdonald*
Discussants	*R. Koskie*
	R. MacLeod
Luncheon Speaker	*R. Schotland*
	" . . . but the pension fund was just sitting there! . . ."

Investment Policy Section

Chairman	*M. Wilson*

Public Sector Pension Funds and Capital Markets: An Overview ~ *John Todd*

Implications of Market vs. Non-Market Investments

Discussion Leader	*R. McDermott*
Discussants	*A. Donner*
	J. Griffin

Venture Investing: An Overview ~ *M. Macdonald*

Economic Enhancement/Social Investing/Corporate Responsibility

Discussion Leader	*B. Purchase*
Discussants	*T. Wohlfarth*
	P. Creighton

Wednesday, June 17

Pension Fund Structure Section

Chairman	*D. Fowke*

Centralized vs. Decentralized Investment Management/Accountability of Pension Fund Governors

Discussion Leader	*B. Mitchell*
Discussants	*A. Reeve* *M. Nadeau* *M. Wilson*
Rapporteur	*D. Slater*
"The Last Word"	*All participants*

List of Participants

Mr. Keith Ambachtsheer
Keith P. Ambachtsheer & Associates Inc.

Mr. Dennis Beggs
President
Dennis Beggs & Associates Ltd.

Mr. James R. Causely
Executive Director
Superannuated Teachers of Ontario

Mr. Robert D. Christie
Director – Finance Policy
Ontario Ministry of Treasury & Economics

Mr. Gordon Cunningham
President
Ontario Hospital Association

Mr. Arthur Donner
A.R.A. Consultants

Mr. A. George Fells
President
S.B. Capital Corporation Limited

Mr. Donald V. Fowke, F.M.C.
Director
William M. Mercer Limited

Ms. Julie Griffin
Executive Vice-President
Ontario Federation of Labour

Mr. Bernie Jones
President
Blue Apple Consulting Inc.

Mr. John Kruger
Chairman
Pension Commission of Ontario

Mr. Don Lee
President
Union Pension Services Ltd.

Mr. Robert Baldwin
Senior Researcher – Legislation
Canadian Labour Congress

Mr. John Bossons
Institute for Policy Analysis
University of Toronto

Mr. James Clancy
President
Ontario Public Service Employees Union

Mr. Philip Creighton, F.C.A.
Task Force on the Churches and Corporate Responsibility

Mr. Bryan Davies
Deputy Minister
Ontario Ministry of Financial Institutions

Mr. D. Don Ezra
Director
Frank Russell Canada Ltd.

Mr. James Fisher
Executive Vice-President
Weston Foods Ltd.

Professor Martin Friedland
Chairman
Ontario Task Force on Inflation Protection for Employment Pension Plans

Mr. Alan Hockin
Dean, Faculty of Administrative Studies
York University

Mr. Ray Koskie
Koskie and Minsky

Mr. Tristram S. Lett
President
Trafalgar Capital Management

Mr. Ron LeNeveu
Assistant Deputy Minister
Administration, Finance and Health Insurance
Ontario Ministry of Health

Ms. Mary Macdonald
President
Venture Economics Canada Ltd.

Mr. William A. Macdonald
Partner
McMillan, Binch

Mr. Donald B. McColl
Assistant Deputy Minister
Office of the Treasury
Ontario Ministry of Treasury and Economics

Mr. Rae MacLeod
Retired Vice President
Manufacturers Life Insurance Company

Mr. Robert Mitchell
Rogers, Casey & Barksdale (Canada) Ltd.

Mr. James E. Pesando
Director
Institute for Policy Analysis
University of Toronto

Dr. George Podrebarac
Deputy Minister – Human Resources
Secretariat
Management Board of Cabinet

Mr. William Rooke
Director
Benefits Policy Branch
Human Resources Secretariat
Management Board of Cabinet

Professor Roy Schotland
Georgetown University Law School

Dr. David Slater
Former Chairman
Economic Council of Canada

Mr. David Stouffer
Principal
William M. Mercer Limited

Mr. Robert Weech
President
Provincial Federation of Firefighters

Mr. Al Reeve
Executive Director
Ontario Municipal Employees
Retirement System

Mr. Jack MacDonald
President
CUPE 1000 (Ontario Hydro)

Mr. Robert W. MacIntosh
President
Canadian Bankers' Association

Mr. Robert McDermott
Partner
McMillan, Binch

Mr. John Milne
Editor
Benefits Canada

Mr. Michel Nadeau
Senior Vice-President
Planning & Depositors Affairs
Caisse de depot et placement du Quebec

Mr. Cliff Pilkey
Member – Ontario Task Force
on Inflation Protection for
Employment Pension Plans

Dr. Bryne Purchase
Assistant Deputy Minister and
Chief Economist
Office of Economic Policy
Ontario Ministry of Treasury & Economics

Ms. Janet Skelton
Manager – Teachers'
Superannuation Fund
Corporate Planning & Financial Management
Ontario Ministry of Education

Mr. Tony Wohlfarth
National Representative
CAW Canada

Mr. John Solursh
Blake, Cassels & Graydon Ltd.

Mr. John Todd
Econalysis Consulting Services

Mrs. Margaret Wilson
Secretary-Treasurer
Ontario Teachers' Federation

APPENDIX G

THE MANY PENSION ROLES OF GOVERNMENT

The government has at least 14 pension related roles and responsibilities. Some of these roles may conflict with one another. Each ministry and agency has its own area of concern, responsibilities and constituencies.

The objective of this appendix is to identify pension related roles and discuss them with respect to the seven large public sector pension funds. The various roles of the government are:

Many Pension Related Roles of Government

1. Legislative
2. Ratifier of Changes to a Pension Deal
3. Regulator
4. Pension Policy Advisor
5. Plan Sponsor
6. Employer
7. Contributor
8. Administrator under the Pension Benefits Act
9. Custodian
10. Investment Policy Maker
11. Investment Manager
12. Guarantor of Pension Benefits
13. Source of Funding for Another Employer
14. Guarantor of an Employer's Debt

Legislative

The Legislature (normally at the initiative of the government) plays two roles with respect to pensions:

1. It determines the overall regulatory framework in which both public and private sector pension plans must operate.
2. It determines, in varying degrees, the specific rules of some, but not all, public sector pension plans and funds, such as the Teachers' Superannuation Fund, Public Service Superannuation Fund, OMERS, Superannuation Adjustment Fund and the Ontario Hydro plan.

   An example of one of the specific roles is the requirement that the TSF invest solely in non-market Ontario debentures.

In addition to the Legislature, the Parliament of Canada through the Income Tax Act influences how pension funds invest.

Ratifier of Changes to the Pension Deal

The executive branch of the Government is involved in approvals to benefit and contribution level changes for the OMERS, HYDRO, WCB and CAATS pension deals.

Regulator

Through the Pension Commission of Ontario, the government monitors compliance of pension funds with respect to the investment regulations established under the Pension Benefits Act.

Pension Policy Advisor

Within government many branches, divisions, Boards and Commissions advise the government on various aspects of rules and regulations, funding and negotiations pertaining to pensions. Often these are the same units which are fulfilling other roles noted in this appendix.

Plan Sponsor

Plan sponsor refers to the organization or body which has the final authority to start a pension plan, make revisions to an existing plan or to wind up a pension plan.

Normally the plan sponsor and the employer are the same. These roles can be separate, however. For example, in the case of the OMERS plan, where the plan sponsor is the Government of Ontario, but municipalities and local agencies are the employers. In the case of the teachers' pension plan, the government is the plan sponsor but school boards are the employers.

For the Colleges of Applied Arts and Technology, the Council of Regents is the plan sponsor, but in practice the government retains considerable approval authority which would normally reside with the sponsor.

Employer

The employer may or may not be the plan sponsor. The government is the employer of public servants and a small number of teachers. In most cases, the employer is responsible for paying the employers' contribution to the pension fund. However, this does not apply to teachers employed by school boards. In this case the plan sponsor makes the contribution.

Contributor

In most but not all cases, the employer is the contributor to a pension fund. The government pays the "employers" contribution to the Teachers' Superannuation Plan even though school boards are the employer.

Administrator

Under the Pension Benefits Act, 1987, which will come into effect January 1, 1988, the Administrator is the person or group which has the direct fiduciary responsibility for the plan and the fund. With most plans who the administrator will be is clear; often it is the company or organization which sponsors the plan. For the PSSF, TSF and SAF, the administrator will be a ministry or agency of the government. In some instances, such as CAAT, who is the administrator is not clear.

Custodian

Custodian means the holders of the financial securities which represent the investments of a pension fund. The Treasurer is the custodian for three pension funds - the TSF, PSSF and SAF. As well, the Treasurer is the custodian of OMERS non-market government debt.

Investment Policymaker

For most plans the parameters of investment policy are set out in the Pension Benefits Act and regulations. Within that legislation, the fund can determine the appropriate asset mix. For the TSF, PSSF and SAF, the Legislature in effect requires these funds to invest in non-market government debt.

Investment Manager

The government is the investment manager only for the TSF, PSSF and the SAF.

Guarantor of Pension Benefits

This role can be divided into two parts, depending on the pension deal:

- the obligation of an employer/plan sponsor to pay the pension promised in a defined benefit plan.
- a specific guarantee, over and above the employer/plan sponsor's obligation, to pay whatever is required to meet the pension promise from the Consolidated Revenue Fund (CRF).

Two public sector funds - the TSF and PSSF - have pension promises "guaranteed" by the employer and a specific CRF guarantee.

Source of Funding for Another Employer

In this role the government finances, in whole or in part, an employer responsible for pension fund contributions and liabilities. Different funding relationships exist, for example:

- a ministry receives from the "government" 100 per cent of the amount required to pay pension contributions for public servants in its employ. The government also commits through legislation to guarantee the pension promise from the CRF.
- a ministry may provide global financing to an employer to pay, in whole or in part, the employer's operating expenses. This applies to CAATS and hospitals. In the case of hospitals, the pension contributions are explicitly provided for in the grants.

There is some question as to whether a ministry's funding role gives it an indirect employer's role. Some argue that it does, since the nominal employer would (could) look to the funding agent to make up any deficiency in their pension fund.

Guarantor of an Employer's Debt

Guarantor here refers to the organization or body which guarantees the debt of another public sector employer.

The government guarantees Ontario Hydro's debt and some universities and hospitals. This raises the question whether the province stands as a kind of indirect employer to those employees for pension purposes. However, the debt guaranteed is related to capital expenditures not general operating costs such as pension contributions.

APPENDIX H

AN ECONOMIC FRAMEWORK FOR ESTABLISHING SURPLUS OWNERSHIP

Keith P. Ambachtsheer

Why This Paper?

This paper proposes an economic framework for establishing the ownership of a surplus in defined benefit pension plans. In the process, it traces possible relationships between actuarial assumptions, contribution rates, investment assumptions vs. results, and a surplus. It is the result of many discussions held over the last six months by the Task Force on the Investment of Public Sector Pension Funds and its consultants. The framework is not held out to contain the final and ultimate answers on this controversial issue . . . but if it serves as an acceptable framework which leads to at least asking the right questions about surplus ownership and pointing towards the direction in which answers lie, it will have served its purpose. While retrospectively it will be virtually impossible to unscramble any surplus eggs, the framework is intended to provide a guide as to what needs to be done if the surplus ownership question is to be successfully tackled prospectively.

SECTION II

Asking the Right Questions

Defined Benefit Pension Plan Models

Following the Ezra paper for the Task Force (The Nature of the Pension Agreement, July 1987), three legitimate (in the sense of being balanced, or fair to both employers/plan sponsors and plan members) defined benefit pension plan models are:

1. A **pure defined benefit plan** where the employer promises the employee a pension based on a specific formula totally unrelated to pension assets, and where the employer undertakes to make any contributions (based at first on initial estimates, and subsequently on some combination of actual experience and subsequent prospective estimates) required to help finance the plan.

2. A **contributory defined benefit plan** which operates exactly as (1.) above, but where the employee is required to contribute a fixed percentage of pay (e.g. 5 per cent) to the financing of the plan, with the employer being responsible for the difference between the expected (and subsequently actual) total required contribution rate for the plan and the constant employee contribution. The typical rationale for the employee contribution is that it permits the sponsor to commit to a higher level of retirement benefits.

3. A **shared risk and reward defined benefit plan** where the employer and the employees agree to split the financing (at first expected and eventually actual) cost, and therefore the required contribution rate, of the plan according to some pre-determined formula (e.g. 50-50).

We next examine how the **expected** required contribution rate is established.

Estimating the Required Contribution Rate

We make a distinction above between financing a defined benefit pension plan and making contributions into such a plan. Contributions into the plan are only one of two financing sources. The other financing source is any return earned on previously made contributions which were not required for benefit payments.

The contribution calculated as required to make subsequent benefit payments will be just the right amount if:

- all the non-investment assumptions (mortality, quit rates, inflation, etc.) were right, and
- the investment return assumption was right

In this (most unusual!) case, the plan will develop neither a surplus nor a deficit.

But even the best 'best estimates' (i.e. estimates that are neither explicitly optimistic nor pessimistic) will not likely exactly work out. So it is a virtual certainty that ongoing defined benefit pension plans being funded on a best estimate basis, will develop occasional surpluses (best estimate assets too large in relation to best estimate ongoing liabilities)...and occasional deficits (now assets too small in relation to liabilities).

A Specific Focus for this Paper

The purpose of the paper is, in this ongoing plan context, to explore what economic logic can tell us about why surpluses or deficits arise, and to explore their possible financial implications for plan sponsors and plan members. Other surplus/deficit issues arise in the plan termination context. Since plan termination is relatively unlikely for the large public sector plans, we do not address these issues in this paper. Also, funding in an ongoing plan is not necessarily based on best estimate investment and non-investment assumptions. For example, with more conservative assumptions, actual contributions would be greater than those expected to be required. Above, we assumed best estimate assumptions. With best estimate assumptions, the required contribution rate is also the best estimate of the wage equivalent value, that is, the cost of an employee's pension entitlement).

SECTION II

Going-Concern Answers

More specifically, our analysis leads to the posing of three basic questions about surplus/deficit implications:

1. What if the non-investment actuarial assumptions lead to the development of a plan surplus or deficit?
2. What if the investment actuarial assumptions lead to the development of a plan surplus or deficit?
3. What if it is not the investment actuarial assumptions but choosing a risky investment policy that leads to the development of a plan surplus or deficit?

There is an important follow-up question:

- How would the answers **differ** for the three defined benefit plan models defined above (i.e. pure defined benefit, contributory defined benefit, and shared risk/reward defined benefit)?

Question 1: The Non-Investment Actuarial Assumption Case

Suppose a certain combination of 'best estimate' assumptions (including one for investment return and inflation) for a given plan led to an estimated required contribution rate of 15 per cent of payroll. Further suppose, five years later, the investment assumption worked out, but the non-investment assumptions didn't. So the 15 per cent of payroll turned out to be too high (in the surplus case), or too low (in the deficit case). Who wins (in the surplus case), or who

loses (in the deficit case)? We answer this question below in the context of the three types of plans.

1. **The Pure Defined Benefit Plan:** it depends on the connection between current compensation, required pension contributions, and subsequent deviations from it:

   a) If current compensation is set **independently** of the pension plan, the employer simply treats both the required pension contribution rate and subsequent deviations from it as part of the cost of doing business. In this case, both plan surpluses and deficits accrue to the employer, and manifest themselves as lower/higher plan contribution rates by the employer. Most private sector employers (especially where compensation is unilaterally set by the employer rather than explicitly bargained) believe their plans fall in this category.

   b) If current compensation and the required pension plan contribution rate are explicitly seen as two distinct components of a **total bargained compensation** package, it implies employees accepted a certain level of current compensation because of a given expectation about the value of the pension accrual, and the current contribution required to pay for it. What if that expectation subsequently turned out to be wrong? In this case, the employee is clearly at risk. He/she either accepted too much current compensation . . . or too little.

   How is such a too much/too little outcome redressed over time? It can be redressed in one of two ways. Plan benefits can be adjusted up or down to reflect the experience gain or less, effectively distributing at least part of the resulting surplus or deficit to plan members. Or current compensation can be adjusted to offset previous pension plan-related under/over contributions. Thus in the integrated total compensation case, both plan surpluses and plan deficits find their way back into adjustments in employee compensation. And these adjustments might be made directly through the pension plan or they might be made through current compensation adjustments.

2. **The Contributory Defined Benefit Plan:** the logic parallels the pure (a) and (b) cases above. Again, if current compensation and the pension plan are completely **segmented**, actuarial gains or losses accrue to the sponsor as adjustments in the required contribution rate (case (a) above). If current compensation and deferred compensation through the pension plan are completely **integrated** (case (b) above), these gains and losses will eventually convert back into adjustments in employee compensation (either current or deferred).

   A new adjustment possibility now is through changing the employee contribution rate into the plan. Indeed, this adjustment possibility is the most likely to be used if there is a perception that the employee contribution rate was not set totally arbitrarily, but was in fact based in part on expected total plan cost. So in this special case, plan members **share** in surpluses (and deficits) through negotiated adjustments in the employee contribution rate.

3. **The Shared Risk and Reward Defined Benefit Plan**: the employer and plan members now automatically share actuarial gains and losses as the contribution rates of both automatically adjust as either surpluses or deficits are revealed.

Question 2: The Investment Actuarial Assumption Case

If there was only one way to invest plan contributions, there would be a 100 per cent parallel between the non-investment assumptions analysis already carried out, and the investment assumption analysis. Either the investment earned the return assumed, or it did not. If it did not, there would be a plan surplus or deficit . . . etc., etc.

But this is not reality. There are investment policy choices to be made. Economic theory suggests that the capital market prices investments so that a spectrum of prospective returns is

always available, based on the perceived riskiness of the available spectrum of investment opportunities.

This reality raises three questions. First, what 'best estimate' return should be used for valuing and costing the benefit? Second, is the 'funding' return the same or different from the 'best estimate' return? Third, what are the implications if the actual pension fund investment policy differs from that assumed for costing and for funding purposes?

The 'Best Estimate' Return Assumption for Benefit Costing and Benefit Valuation

Where a financially sound employer stands behind the pension promise, the return assumption for the benefit costing and valuation should be the most certain return the capital markets offer **given the nature of the pension liability**. This kind of return is often referred to as the 'risk free rate of return.' Where the pension liability is effectively **nominal**, this would be the yield on a high quality bond portfolio of appropriate duration. Where the pension liability is effectively **real**, this could be the expected long-term return on Treasury Bills (in the absence of inflation-indexed long-term high quality bonds) or some broader based, variable rate, high quality debt portfolio.

Suppose that the benefit promised in our example above is effectively a real benefit. Costing then requires coming up with the best estimate of the future rate of return with a low risk, real return strategy. The long-term return on such a strategy is unknown, but is generally accepted to fall into a 1 to 3 per cent real return range.

(We recognize that the view that the return [i.e. discount rate] used for valuing and costing pension entitlements should be based on a risk-free investment policy [given the nature of pension liabilities] is a novel one for some readers. But this view embodies an important principle. It is that any incremental investment return earned by adopting a risky policy is **not** a "free good." The **cost** of earning this incremental return is the acceptance of investment risk. And that cost [even if it is not always properly accounted for] must be borne by someone. In the Pure Defined Benefit and Contributory Defined Benefit Plan cases defined above, this investment risk is borne solely by the employer/plan sponsor. In the Shared Risk and Reward case, it is shared by plan members and the employer/plan sponsor).

The Actual Risk-Free Return

The actual return on a low risk/return portfolio will probably not be exactly equal to the previously made best estimate return. It will be higher or lower. Therefore the initial cost estimate will be set either too high or too low. If the returm estimate is also used to set the initial contribution rate, it too will have been set too high or too low.

Plan surpluses or deficits from this source can be taken through the same economic logic as we took surpluses and deficits from non-investment sources . . . and therefore we arrive at the same conclusions as we did above.

Summary Comments on Questions 1 and 2

Expected plan costs fall out of a complex set of actuarial calculations involving both non-investment and investment best estimate assumptions. As noted earlier in the Appendix, plan funding can be based on these best estimate pension expense calculations, which are already conservative in the normal use of this word (because the return assumption used relates to the return on risk free investments). Alternatively, the plan contribution rate can be based on an even more conservative basis by building margins of safety into the non-investment assumptions (i.e. mortality, quit rates, wage escalation, etc.). Other factors related to the plan sponsor's tax status and financial condition can also come into play in setting the actual funding policy.

The more conservative the actuarial funding assumptions, the more likely it is that a pension plan will ultimately develop a surplus. Understanding this is extremely important in the integrated total compensation case. In this case, we have argued that plan members could

have a claim on at least part of this emerging surplus. This is so if the higher-than-required plan contribution rate translates into a lower-than-would-otherwise-be-the-case level of current compensation.

The reader should note that both price and wage inflation are part and parcel of these actuarial assumptions. Thus higher or lower than anticipated inflation rates can contribute to a plan deficit or surplus the same way as other actuarial assumptions can.

Whether the ultimate result of actuarial assumptions vs. subsequent reality leads to surpluses or deficits in defined benefit pension plans, we call such surpluses or deficits '**actuarial**' in the sense that they resulted from differences between actuarial assumptions and subsequent actual experience.

Question 3: Choosing a Non-Risk Free (i.e. Risky) Investment Policy

Over the long term, a 50-50 stock-bond portfolio should outperform a low risk real return strategy such as a 100 per cent Treasury Bill portfolio. Why? Because it is perceived to be a riskier strategy. To get investors to hold riskier portfolios, they need to be 'bribed' with the prospect of earning a higher rate of return over the long run. Over long historical measurement periods, 50-50 stock-bond portfolios have in fact outperformed Treasury Bill portfolios. But, to prove the point about perceived riskiness, during bad economic times like much of the 1970's, the 50-50 portfolio performed poorly, significantly underperforming the Treasury Bill portfolio.

Because of the nature of pension deals (1.) and (2.) above, the plan sponsor can make a decision to invest pension contributions in the 50-50 portfolio rather than the 100 per cent Treasury Bill portfolio. The sponsor would do this if it was willing to trade off temporary (hopefully!) bad spells in the capital markets against the prospect of earning a rate of return in excess of the Treasury Bill rate over the long term.

If this strategy is successful over the long term, a contribution rate set on the basis of earning only the Treasury Bill rate of return will over time turn out to be too high. A risk premium-related plan surplus (or '**investment risk surplus**' for short) will develop. We now turn our attention again to the "who benefits?" question.

Who Benefits from a Risk Premium-Generated Plan Investment Surplus?

Let's say the 50-50 investment policy earns 300 Basic Points (3 percentage points) more than the Treasury Bill strategy over the long term. Let's also say Treasury Bills earn their expected rate of return and that non-investment plan experience works out as expected. Who 'owns' the emerging investment risk surplus?

From an economic logic standpoint, the answer would appear rather straight forward: whoever stood to lose from the 50-50 policy during those bad spells in the capital markets. Going through the three plan cases:

1. **The Pure Defined Benefit Plan:** in the **segmented** (i.e. no negotiated connection) case, it is the plan sponsor who bears the investment risk and should benefit from any emerging investment risk surplus. In the **integrated** case, the answer depends on whether risk premium-related plan deficits feed back into subsequent downward adjustments in plan member compensation. If they don't, it is the plan sponsor who bears all of the investment risk and should solely benefit from any emerging surplus. If risk premium-related plan deficits do feed back into subsequent downward adjustments in plan member compensation, plan members are indirectly bearing some of this investment risk and therefore should share in some of any emerging risk premium-related surplus. This in fact will likely happen naturally through the negotiation process over time.
2. **The Contributory Defined Benefit Plan:** exactly the same commentary as (1) above. Except now any investment risk surplus or deficit sharing in integrated compensation situations could in addition be done through adjustments in the employee contribution rate.

3. **The Shared Risk/Reward Defined Benefit Plan:** here the 50-50 asset mix would be set with direct plan member involvement, because the contribution formula has made the reality of risk sharing explicit. Investment gains or losses now automatically convert into contribution rate adjustments over time for both parties. Alternatively, plan members could convert their portion of the investment gains or losses into adjustment in pension entitlements.

SECTION III

Concluding Thoughts

Establishing surplus ownership in the going-concern mode is simple in two extreme cases:

- A pure defined benefit arrangement with a clear segmentation between current compensation and the pension plan. Here surplus (deficit) ownership always lies entirely with the plan sponsor. However, this type of arrangement is few and far between in the Ontario public sector.
- A shared risk defined benefit arrangement where the risk-sharing formula is explicit. Here surplus (deficit) ownership is always apportioned according to the explicit formula. This type of arrangement is also not overly common in the Ontario public sector.

Things get very complicated in the integrated compensation cases with both pure and contributory defined benefit pension plans. The reason is that generation of actuarial surpluses (deficits), lead to subsequent compensation (either current or deferred) adjustments for plan members. This may (or may not) be the case for the generation of investment surpluses (deficits) as well. The large Ontario public sector plans seem to fall in the integrated compensation contributory defined benefit category when the plans are perceived to be in surplus. They move to segmented schemes when perceived to be in deficit.

The only obvious way to avoid these complications while retaining a defined benefit pension arrangement is to stick to one of the two clear cases: pure defined benefit with current and deferred compensation segmentation, or a defined benefit scheme where surpluses (deficits), no matter what their source, are shared through some explicit, pre-determined formula.

APPENDIX I

A SUMMARY DESCRIPTION OF THE CAISSE DE DEPOT ET PLACEMENT DU QUEBEC

This appendix on the Caisse de depot et placement du Quebec is in two parts:

- Part one is a summary description of the Caisse, its history and objectives, its organization, and its investment practices and criteria.
- Part two comprises some general observations on the Caisse from four perspectives: size, potential conflict (subsidy), asset mix and other objectives.

Part 1

The Caisse de depot et placement du Quebec is an autonomous institution established under its own legislation to manage centrally the investment of a number of Quebec pension and insurance funds. In 1986, 20 years after its founding, the Caisse ranked as Canada's sixth largest financial institution with investments totalling approximately $28 billion.

1. History and Objectives

The Caisse de depot et placement du Quebec was formed in 1965 to manage funds of various public sector pension and insurance plans. The Caisse has two objectives:

- generate returns through sound investment management; and
- support Quebec's economic development.

To achieve these objectives, the Caisse has invested funds in a variety of investment vehicles including bonds, shares, convertible securities, mortgages and real estate. As of December 31, 1986 the Caisse had $28 billion under management, valued at market.

2. Organization of Investment Funds

Figure 1 is a schematic representation of nine investment funds and one specialized portfolio managed by the Caisse as at December 31, 1986.

Investment Funds Managed by Caisse de depot et placement du Quebec

December 31, 1986: $Million

One General Fund

General Fund $17,411.8	Quebec Pension Plan ($13,557.6) Quebec Automobile Insurance Plan ($3,842.9) Agriculture and Forestry Insurance Fund ($11.3)

Eight Individual Funds

Fund 301 $5,000.3	Fund 302 $1,205.7	Fund 303 $27.4	Fund 304 $19.0
Government and Public Employees Retirement Plan (Unionized)	Government and Public Employees Retirement Plan (Non-union)	Individual Plans (closed)	Retirement Plan for Mayors and Councillors

Fund 305 $1,315.8	Fund 306 $533.0	Fund 307 $66.0
Supplemental Pension Plan for Employees in Construction Industry		
Actives	Retirees	Additional Contributions

Fund 308 $2,287.3
Quebec Workers' Compensation Fund

One Specialized Fund

Real Estate $444.8	Seven of the above nine funds held units in this specialized fund: General Fund and Individual Funds 301, 302, 311, 312, 313, and 330.

Source: Financial Statements and Financial Statistics, 1986
Caisse de depot et placement du Quebec

FIGURE 1

Figure 2 summarizes the level and distribution of depositors' holdings in the Caisse.

The General Fund is the largest investment fund and has assets with a market value of $17,411.8 million. The General Fund manages the assets of the Quebec Pension Plan, the Quebec Automobile Insurance Plan and the Agriculture and Forestry Loan Insurance Fund. The Quebec Pension Plan, with $13,557.6 million in assets, is by far the largest of the three participants.

The Caisse manages eight individual funds with combined assets of $10,534.5 million. Each individual fund has only one depositor and seven of the eight funds hold pension plan assets. Fund 301, which holds the pension assets of the Government and Public Employees Retirement Plan (Unionized), is the largest at $5,080.3 million. Fund 302 holds the pension assets of non-union employees. Unlike the other individual funds, Fund 301 and Fund 302 hold only employee contributions. Associated employer contributions are deposited in the Consolidated Revenue Fund of the Province of Quebec.

Level and Distribution of Depositors' Holdings at the Caisse de depot et Placement du Quebec

December 31, 1986

	Holdings[1]	
General Fund	**($ Millions)**	**(%)**
Quebec Pension Plan	$13,557.6	48.51
Quebec Auto Insurance Plan	3,842.9	13.75
Agriculture and Forestry Loan Insurance Fund	11.3	0.04
Sub-Total	$17,411.8	62.30
Individual Funds		
Government and Public Employees Retirement Plan		
Unionized	$5,080.3	18.18
Non-Unionized	1,205.7	4.31
Retirement Plan for Mayors & Counsellors	19.0	0.07
Individual Plans	27.4	0.10
Workers' Compensation Fund	2,287.3	8.18
Supplemental Plan for Employees of Quebec Construction Industry		
Actives	1,315.8	4.71
Retirees	533.0	1.91
Additional contributions	66.0	0.24
Sub-Total	$10,534.5	
Other Items	1.9	—
TOTAL	$27,948.1	100.0

Source: Financial Statements and Financial Statistics 1986, Caisse de depot et Placement du Quebec.
[1] Includes accrued interest and income, and demand deposits held in the General Fund.

FIGURE 2

Fund 303 holds the assets of various closed municipal and hospital pension plans. Fund 304 holds the assets of the pension plan for mayors and municipal councillors. Funds 311, 312 and 313 hold the pension assets of the pension plan covering Quebec construction workers. The combined value of the assets in these three funds at the end of 1986 totalled $1,914.8 million. Fund 330 holds the assets of the Workers' Compensation Plan.

The Caisse also manages one specialized portfolio with real estate investments. Any of the above nine investment funds can participate in this portfolio through unit purchases. At the end of 1986, seven of the nine investment funds had purchased units and the specialized portfolio had a market value of $444.8 million.

3. Management Structure

Figure 3 is a schematic representation of the management of the Caisse. A nine-member Board of Directors, all appointed by the Government of Quebec, is responsible for the Caisse's investment policy and administration. Operational responsibilities, including the implementation of the Board's investment policy and strategies, reside with the staff of the Caisse.

Management Structure of Caisse de depot et placement du Quebec

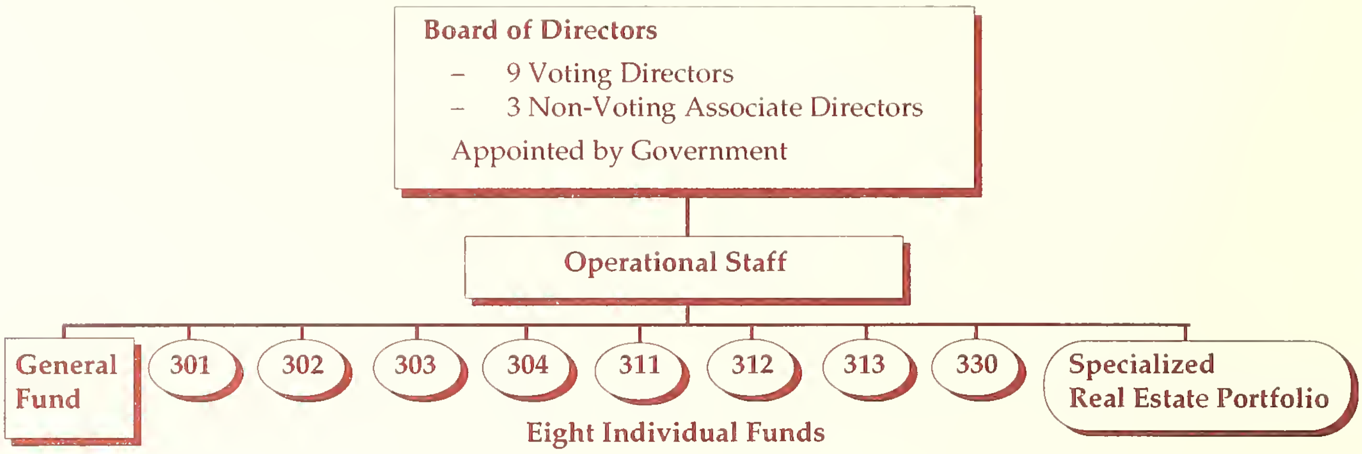

FIGURE 3

The Chairman of the Board is the General Manager of the Caisse, who is appointed for 10 years. The Chairman cannot be removed without the agreement of two-thirds of the Quebec National Assembly. The Vice-Chairman is the President of the Regie des Rentes du Quebec (the Quebec Pension Plan or QPP).

The seven other members are appointed for three years. Two of the seven must be chosen from among officers of the Government or directors of a government agency, another must be selected from among union representatives of employees and another must be selected from among directors of cooperatives. There is no restriction imposed on the selection of the remaining three members of the Board, but they are usually selected from the private sector.

Finally, the Board of Directors has three non-voting associate members. They are the Deputy Minister of Finance, a senior official of Hydro-Quebec attached to the finance branch and one member of the Municipal Commission of Quebec or an officer of the Ministry of Municipal Affairs.

Administration of the plans with deposits at the Caisse is the responsibility of the individual organizations concerned.

4. Investment Practices and Criteria

The Caisse aims overall to have a similar asset mix to those of the top public sectors funds in the U.S. The Caisse must also match the asset mix to the needs of its depositors. The depositors have the right to give the Caisse policy direction on the investment of the funds. The Caisse meets with each depositor four times a year, twice to review investment returns, and twice to plan asset mix for the succeeding year.[1]

Legislation governing the Caisse includes various investment criteria. The principal provisions are:

(1) The Caisse may acquire and hold without restriction bonds issued or guaranteed by the Government of Quebec, bonds issued by any other government and bonds issued by the International Reconstruction and Development Bank;

[1] Meeting with Michel Nadeau, Senior Vice-President, Caisse de Depot, and Jean Trudel, Senior Vice-President, Caisse de Depot, Montreal, Quebec, March, 1987.

(2) The Caisse may not acquire bonds of a municipality or school corporation that would increase the amount held to more than 20 per cent of the outstanding indebtedness of the municipality or school corporation;

(3) The Caisse can acquire and hold without restriction mortgages whose principal and interest is guaranteed by the Province of Quebec;

(4) The Caisse's total investment in other mortgages cannot exceed 10 per cent of its total assets;

(5) The Caisse may not hold more than 30 per cent of the common shares or a class of common shares of any one company;

(6) The Caisse may not invest more than 30 per cent of its total assets in common shares; and,

(7) The Caisse may invest or make loans not authorized by legislation to a maximum of 7 per cent of its total assets, but it may not invest more than 1.0 per cent of its total assets under this provision in more than one company or undertaking.

Part II – Some General Observations

This part looks briefly at the Caisse from four perspectives:

- Size
- Potential conflict between its economic development objective and its fiduciary responsibilities (i.e. does the Caisse provide a subsidy to a region, industry, individual company or individual as a result of its economic development objective?)
- Asset mix
- Other objectives

It is based on discussions which the Task Force had in Quebec as well as on written analyses of the Caisse.

Size

Invariably we were advised that a pension fund the size of the Caisse can unduly influence the capital market. As a result, for the most part, we were advised not to recommend centralizing Ontario's pension funds.

We were told that if Ontario decides to centralize its pension funds, it should recognize that pure market criteria will not be enough and that some method for "allocating" investments will be required. As well, exceptional restraint would be required of the centralized pension fund management and the Government to avoid "excesses" which arise from the ability to "make" markets.

Others advised that the more players there are in the capital market, the more efficiently the market operates.

Potential Conflict (Subsidies)

The mandate of the Caisse is two-fold:

- to generate returns through sound investment management (i.e. a fiduciary objective)
- to support Quebec's economic development.

There is a widespread belief in the investment community and elsewhere that in order to achieve its economic development objective, the Caisse compromises its fiduciary responsibilities.

Most individuals we spoke to stated that the Quebec Government gives the Caisse no directives other than are set out in the legislation.

We were also told that no subsidies are given by the Caisse to the companies it invests in. Indeed, the management of the Caisse strongly disagree with those who see the Caisse as an investment agency which responds to direction from the Government (beyond that set out in legislation).

It is the Caisse's view that its primary objective is to achieve market returns. In the course of doing this, the Caisse also tries to contribute to economic development. And thirdly, it contributes to public financing, helping to maintain a market for Quebec government and government-guaranteed bonds and helping to reduce the interest rate spread between those bonds and Government of Canada bonds.

James Pesando, however, is of the view that the potential for conflict clearly exists, both when the Caisse assumes an active management role in one of its investments and when it assumes a passive role. He states "the source of the potential conflict is the possibility of inefficient diversification."[2]

Pesando goes on to say that:

> *Promoting the economic development of Quebec could involve either the redress of a market failure or the delivery of a subsidy to promote the growth of a firm or industry beyond that suggested by extant market forces. Yet the **potential** for a "province-building" role for public sector funds is likely to be limited largely to their purchase of shares in small- or medium-sized firms whose shares are not traded on an organized exchange, if the fund remains a passive investor. The ability of a public sector fund to deliver a subsidy if its activities consist of the purchase or sale of actively traded securities is quite limited. If these activities are to be used to promote economic development, the suggestion to many is that they must entail the adoption of a managerial role by the Caisse. Further, if this managerial role is not simply to duplicate the efforts of extant management, it must involve other than the maximization of shareholder wealth as an objective.*
>
> *There is evidence that existing shareholders of Domtar suffered windfall losses at the times of the announcements (9 July 1979 and 18 August 1981) of the Caisse's purchase of Domtar shares. This **suggests** that market participants may assign a non-wealth-maximizing motive to the directors of the Caisse. It also draws attention to both the equity and efficiency issues discussed in the text. Additional empirical work on the announcement effects of share purchases or like activities by the Caisse (such as seeking board representation) is a promising area for future research.*
>
> *The perception exists that the Caisse may seek to alter real investment or like decisions of firms whose shares it holds. This **perception** could raise the required rate of return on firms who are or could be potential targets for such pressures. It is virtually impossible to determine if this in fact has happened.* [3]

Asset Mix

Many people think of the Caisse as a monolithic investment agency. In fact, it has nine investment funds and a specialized real estate portfolio.

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[2] *An Economic Analysis of Government Investment Corporations, with Attention to the Caisse de depot et placement du Quebec,* James E. Pesando, Discussion paper 277, Economic Council of Canada, March 1985, Page 3-26.

[3] *An Economic Analysis of Government Investment Corporations, with Attention to the Caisse de depot et placement du Quebec,* Pages 3-26 and 3-27.

The asset mix of the various funds differs. For example, the General Fund has an asset mix of 70 per cent bonds and 30 per cent equities. The government and public employees retirement fund, on the other hand, has a more balanced bond and equity asset mix.

As a result of these different asset mixes, the rates of return of the different funds vary.

Other Objectives

During our discussions, we were reminded frequently that the Caisse has played an important role in developing a cadre of financial and investment expertise in the province of Quebec. The first investment responsibility of the Caisse was the Quebec Pension Plan. Only later was it given the responsibility to manage the assets of pension, insurance and various provincial agricultural and resource agencies. For example, the Government and Public Employees Retirement Plan, the assets of which are managed by the Caisse, was not established until 1974.

Initially, at least, the establishment of the Caisse appears to have been motivated in part by the desire to have an institution which could develop the financial and investment skills of French-speaking Canadians.

In this the Caisse has been highly successful. A similar need during the mid 1960's did not exist in Ontario and does not exist today.

APPENDIX J

THE LAW OF FIDUCIARIES IN THE CONTEXT OF THE PENSION DEAL
A DISCUSSION MEMORANDUM

David Wentzell, McMillan, Binch

Introduction and Overview

This memorandum examines in brief a number of concepts relating to the law of fiduciaries. The approach taken has been to consider the issues in a general way in order to establish a foundation from which to explore the fiduciary relationships to be found in the context of the pension deal.

The major conclusions are as follows:

1. A fiduciary relationship will exist between two parties, the fiduciary and the beneficiary, when the fiduciary has a power, the exercise of which affects the rights or interests of the beneficiary, coupled with a duty of loyalty in the exercise of the power.
2. A trustee is a fiduciary, although not all fiduciaries are trustees.
3. The administrator of a pension plan is a fiduciary. The fiduciary obligations of the administrator are prescribed by the **Pension Benefits Act**, 1987.
4. A fiduciary is required to exercise his power with the diligence, skill and care of an ordinarily prudent person in like circumstances.
5. A fiduciary is accountable to his beneficiary for breach of the duty of loyalty. Breach of the duty of loyalty gives the beneficiary a cause of action.
6. The general standards of care in fiduciary relationships are applicable to pension fund fiduciaries.
7. Plan members and employers may, depending upon the circumstances, be the beneficiaries of pension funds. Plan members and employers may be beneficiaries of the same pension fund simultaneously.

The Law of the Fiduciaries in General

The Fiduciary Relationship

When one attempts a definition of "fiduciary" it becomes clear at an early stage that the law does not offer a concrete set of building blocks with which to fashion the definition. The concept is a vague one that has been applied by the courts in countless fact situations, often where there was no other foundation for a remedy for a deserving applicant.

Trustees are easily characterized as fiduciaries. The association is so strong that it is often the layman's perception that the two concepts are synonymous. This is not the case. While all trustees are fiduciaries, not all fiduciaries are trustees.

It might be said that the facts of each case will determine whether a fiduciary relationship exists. Partners, directors of corporations, shareholders, employees, lawyers, doctors, municipal politicians, real estate salesmen, investment counsellors and stock brokers have all been held by the courts in various circumstances to have fiduciary obligations.

It can fairly be said that the categories of fiduciary relationships remain open and new dimensions are added to the law regularly. Two recent decisions of the courts of Ontario serve as examples. In *International Corona Resources Ltd.* v. *Lac Minerals Ltd.* (1986), 53 O.R. (2d) 737, the court held that Lac had a fiduciary duty, having learned of the results of the Corona exploratory drilling, not to acquire the adjacent lands and mineral rights. In *Standard Investments Ltd.* v. *Canadian Imperial Bank of Commerce* (1985), 52 O.R. (2d) 473, the Ontario Court of Appeal held that the directors of the bank breached a fiduciary duty by acting so as to prevent the plaintiffs from successfully completing a business transaction.

The difficulty of distilling an "all-purpose" definition of the fiduciary relationship is obvious. J.C. Shepherd in *The Law of Fiduciaries* proposes the following basic theory of fiduciary relationships:

> *A fiduciary relationship exists whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient of the power uses that power. (p.96)*

This theory is in keeping with the approach taken by Mr. Justice Laskin in *Canadian Aero Service* v. *O'Malley* (1974) 40 D.L.R. (3d) 371. The decision of the Supreme Court of Canada rejected reliance upon a series of rigid rules relating to fiduciary obligations and admonished the courts to determine each case on its facts in light of the general standards of loyalty, good faith and avoidance of conflict of duty and self-interest.

A key element of the fiduciary relationship is the fact that the fiduciary's powers are subject to the fiduciary's duties to his beneficiary. A duty is an obligation requiring the fiduciary to act in a particular way. A power is an ability and authority permitting, but not requiring, the fiduciary to act in a particular way.

Although the definitions of duty and power can be stated simply, it is often difficult to draw the line between a fiduciary's duty and his power. As the theory of fiduciary relationships adopted by Shepherd illustrates, the basic duty of a fiduciary is to exercise his power in the best interests of his beneficiary. This over-riding duty may be called the duty of loyalty.

Two broad elements of the duty of loyalty may be identified. A fiduciary has a positive duty to act in the interest of his beneficiary. For example, a fiduciary may be obliged to obtain the best price on a sale of property of the beneficiary. A fiduciary has a negative duty not to act in his own best interests. For example, a fiduciary may be obliged not to use information obtained by virtue of his office for his personal gain.

The duty of a fiduciary with investment powers has often been considered by the courts. Such a fiduciary is bound to exercise his investment powers in the best interests of his beneficiary taking the care that an ordinary prudent man would take if he were making the investment for another person. This introduces an additional concept, the standard of care.

A standard of care is the measure of the conduct required of a trustee in the exercise of his powers. Some commentators consider the standard of care to represent a duty of the fiduciary. However we prefer the view that is fulfilling each of his duties and in exercising each of his powers a fiduciary must live up to a minimum standard of care.

In analysing the adequacy of a fiduciary's conduct there are two basic questions. First, did the fiduciary meet the obligations inherent in the duties imposed on him. Second, did the fiduciary's act in exercising his powers meet the required standard of care, skill and diligence. This standard of care is discussed in more detail in the section dealing with the concept of prudence.

The Trustee

We have seen that a trustee is a fiduciary with duties of loyalty to the trust beneficiaries. What then is a trust? A trust is a concept developed by the courts of equity in England to be applied to the circumstance where a person is given legal title to property, the beneficial interest in which is vested in another person, the beneficiary.

At the basic level a trust results in the separation of the legal title and the beneficial interest in the trust property. An express trust is one that meets the test of the three certainties. First, there must be a clear intention of the parties involved to create a trust. Second, the property that is the subject of the trust must be identifiable. Third, the beneficiaries of the trust must be identifiable.

A trustee will generally have a number of duties to be fulfilled in the exercise of the trust powers. Foremost is the duty of the trustee to carry out the intention of the settlor. The settlor is the person who creates the trust by giving, or settling, property to the trustee to be held subject to the terms of the trust agreement.

There may in fact be more than one settlor of a trust, just as there may be more than one beneficiary. A settlor may also be a beneficiary of the trust to which he has made a contribution of property.

The trustee draws his powers and the purpose of the trust from the document establishing the relationship. There is no restriction upon who may determine the contents of the trust document. Depending upon the circumstances a trust may be unilaterally established by a settlor, or collectively negotiated by two or more of the settlors, trustee and beneficiaries.

Underlying the trustee's fundamental obligation to carry out the purpose of the trust are three duties applicable to all trustees:

- First, unless expressly authorized to do so, a trustee may not delegate the exercise of his discretion to others.
- Second, a trustee has a duty not to benefit personally from his position as trustee. This places an obligation on the trustee not to profit from his dealings with the trust property.
- Third, and of equal importance, is the obligation of a trustee to treat beneficiaries equally. This is often referred to as the duty to maintain an even hand.

A trustee's duties as well as his liabilities may be expanded or limited by the express terms of the document establishing the trust.

The standard of care imposed upon a trustee in his exercise of his duties requires him to honestly exercise his best judgment, taking the same care and exercising that degree of skill that a prudent man would take in the administration of his own affairs.

A more onerous standard of care has developed for trustees' exercise of investment discretion. In exercising a power of investment, a trustee must temper his actions with the "care that a prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide" (*Re Whiteley* (1886), 33 Ch.D. 347 at 355 (C.A.) per Lindley, L.J.).

The Prudent Person Standard of Care

In determining whether a trustee has discharged his duties in an acceptable manner, the courts have measured performance against the yardstick of the man of ordinary prudence. (The concept of prudence, with emphasis upon the pension deal is the subject of a discussion paper by Keith Ambachtsheer which is Appendix L to the Task Force Report).

There are a number of formulations of the standard of prudence to be found in the reported cases. An example of two of the variations is seen in the different test said to be applicable to the exercise of a trustee's investment powers. Here, it is said that the trustee must exercise the degree of care that a prudent person would exhibit when investing other peoples' money. Whether the other peoples' money test in fact creates a higher standard of care is a difficult question. It was obviously intended that if a person is more careful with investments of another's money that such greater degree of care be exercised by trustees in investing trust funds.

The key concern in all cases is that prudence is exercised in light of the particular circumstances. In the exercise of a discretion respecting investments, the trustee must consider a number of factors, including the market conditions, the quality of the investment, the length of time the investment will be held, the nature of the trust and the interests of the beneficiaries. The investment portfolio must be considered as a whole. This requires the trustee to turn his mind to whether there is a need for diversification of the trust investments.

When the question of the prudence of a trustee's actions comes before a court, it is appropriate that the situation is judged without the benefit of hindsight. A trustee will not be liable if the decision in question is one that an honest and reasonable person could have taken in the same circumstances.

The standard of care developed by the courts is often incorporated in legislation relating to the conduct of those in a fiduciary capacity. The statutory formulations of the standard of care may contain nuances that require a particular reference point in setting the level of satisfactory prudence. For example, the Business Corporations Act, 1982 expressly requires directors to act in the best interests of the corporation.

Fiduciary Accountability

The issue of fiduciary accountability involves two concerns. First, how does the fiduciary report to his beneficiary. Second, what mechanisms hold the fiduciary accountable for his actions.

The first aspect of accountability is an important one. A beneficiary must be informed as to the acts of the fiduciary so as to ensure that the fiduciary is conducting himself properly. There is no generally applicable standard of reporting other than what is reasonable in the circumstances. A fiduciary may be specifically required by the terms of the governing documents to account to his beneficiary in any manner considered appropriate by the parties For example, an investment counsellor may be required to provide periodic statements showing transactions in the managed portfolio.

The second aspect of accountability involves a breach of duty or a failure to meet the required standard of care. A fiduciary will breach his fiduciary obligations any time he fails to exercise his powers in strict compliance with his duty of loyalty. If the fiduciary's duties are contained in a declaration of trust, a contract or a statute, whether or not there is a breach will be determined by reference to the language of the document or legislation.

A fiduciary's liability was originally a strict one. If there was so much as a technical breach of the obligation, causing a loss, the fiduciary would be liable. Today the courts will excuse a technical breach where the fiduciary has acted honestly and with reasonable prudence. That is, where his actions meet the necessary standard of care. In fact section 35 of the **Trustee Act** gives the courts the statutory power to grant relief to trustees in circumstances of technical breach.

If a fiduciary's conduct is not excused as an honest and prudent act, he may be liable not only where he has profited at the expense of the beneficiary but also where by an act or failure to act, the beneficiary has not realized the full benefit to which he was entitled.

A fiduciary is accountable to his beneficiaries for any loss occasioned by the breach of the fiduciary obligation. Typically a beneficiary's recourse is to take action against the fiduciary in the courts. The courts will not punish the fiduciary but will require the fiduciary to compensate the beneficiary's loss.

In addition to the beneficiary's rights against his fiduciary, the beneficiary also has a right to recover any property in the hands of the fiduciary that was subject to the fiduciary relationship. Rights with respect to property will most commonly exist where the fiduciary relationship is one of trustee - beneficiary. The rights of the beneficiary include the right to trace the trust property if it has been substituted, transferred or otherwise improperly dealt with by the trustee.

In the context of the pension deal, most pension trust agreements require accounting statements to be made by the trustee. The statutes and regulations governing the large public sector pension funds contain a number of accountability requirements. Annual audits and annual reports to the Legislature are required in most cases.

Fiduciary Considerations in the Pension Deal

Application of the General Rules

There are a number of fiduciary relationships in the typical pension deal. The pension fund trustee is a fiduciary, the employer who receives employee contributions is a fiduciary, the

investment counsellor who provides advice to the pension fund is a fiduciary, the administrator of the pension plan is a fiduciary.

We have seen that in every fiduciary relationship there is a beneficiary to which the duty of loyalty is owed. In the context of the pension deal the most obvious beneficiary is the pension plan member who is entitled to benefits under the plan. Also included in the group of beneficiaries are the plan member's spouse, dependents or estate, to the extent they have an entitlement, vested or contingent, to benefits under the plan.

Less obvious, but equally valid is the interest of the employer as beneficiary. An employer's interest as a beneficiary will arise for example, in the case of a defined benefit plan under which the employer is entitled to surplus assets. The employer may be both the settlor and a beneficiary of the pension trust at the same time.

The general rule is that anyone who has a beneficial interest in the property of a trust, whether the interest is vested or contingent, is a beneficiary of the trust. The facts of each case must be examined to determine who is the beneficiary of a pension trust or other pension fiduciary relationship.

Subject to the provisions of specific legislation to the contrary, the fiduciary relationships of a pension deal are governed by the ordinary principles of the law of fiduciaries. This approach has recently received the sanction of the Chancery Division of the Court of Queen's Bench in England in the case of *Cowan v. Scargill* (1984) 2 All E.R. 750. The case involved the U.K. coal miners' pension fund. The union trustees took the position that the fund should adopt an investment policy that supported the English coal industry.

This policy would require the divestiture of all overseas investments and prohibit any investment in energy industries in direct competition with coal. The union trustees refused to approve the investment policy for the fund unless it met these criteria. The question before the court was whether this refusal was a breach of the union trustees' fiduciary duties.

The court considered directly the question whether the general law of trusts is applicable to the trusts of pension funds. The answer was an emphatic yes. The court noted:

> *I can see no reason for holding that different principles apply to pension fund trusts from those which apply to other trusts. Of course, there are many provisions in pension schemes which are not to be found in private trusts, and to these the general law of trusts will be subordinated. But subject to that, I think that the trusts of pension funds are subject to the same rules as other trusts. The large size of pension funds emphasizes the need for diversification, rather than lessening it, and the fact that much of the fund has been contributed by members of the scheme seems to me to make it even more important that the trustees should exercise their powers in the best interests of the beneficiaries. In a private trust, most, if not all, of the beneficiaries are the recipients of the bounty of the settlor, whereas under the trusts of a pension fund many (though not all) of the beneficiaries are those who, as members, contributed to the funds so that in due time they would receive pensions. It is thus all the more important that the interests of the beneficiaries should be paramount, so that they may receive the benefits which in part they have paid for. (p. 763)*

In this passage the court emphasizes the fact that members may have contributed to a pension fund trust. This places an extra importance upon the requirement that the beneficiaries' interests be served. In our view the approach does not vary if the pension plan is a defined contribution plan rather than a defined benefit plan. The beneficiaries' interests are paramount. Of course, in a defined benefit plan the employer contributor to the plan may also be a beneficiary of the plan.

The court also provided a review of the guiding principles of trust law that we have already discussed. The trustee must carry out the object of his trust. The trustee must only delegate the exercise of his discretion when expressly authorized. The trustee must not profit personally from his office. The trustee must maintain even treatment of his beneficiaries. The words of the judgment are useful as a summary of the law of England and Canada. On the question of maintaining an even hand between beneficiaries the court said:

> *The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment. (p. 760)*

As a general statement it can be said that where trustees are representatives of an identifiable constituency they may not advance the interests of that constituency at the expense of other beneficiaries of the trust. This principle would apply to the representatives of employers or plan members on the boards of public sector pension funds. The court offered this comment on the possible conflicts between social views and investment of trust funds.

> *In considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reasons of the views that they hold. (p. 761)*

This passage from the reasons for judgment in the *Cowan* case serves as a focus for a discussion of the situation of trustees that are directed to make certain investments or refrain from other investments.

A trustee's obligations are subject to the overriding limitation of the relevant trust documents. If the documents restrict the trustee to a particular class of investments, the trustee will not be reproached for abiding by that restriction even though prohibited investments might have been wiser choices for the trust.

The discretion of the trustee is limited by the restriction in the trust document. In effect the liability for the prudence of the resulting investment policy has been shifted from the trustee (he has no discretion now) to the person or persons that framed the language of the trust document. Depending upon the circumstances that may be the employer either along or in collective negotiation with his employees. The liability to ensure that the decision to restrict the trustee's investment discretion is prudent rests with the parties making that decision.

The court provided this insight with respect to investments and the degree of prudence required to be exercised:

> *That duty includes the duty to seek advice on matters which the trustee does not understand, such as the making of investments, and on receiving that advice to act with the same degree of prudence. This requirement is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness. Some of the most sincere people are the most unreasonable; and Mr. Scargill told me that he had met quite a few of them. Accordingly, although a trustee who takes advice on investments is not bound to accept and act on that advice, he is not entitled to reject it merely because he sincerely disagrees with it, unless in addition to being sincere he is acting as an ordinary prudent man would act. (p. 762)*

The result of the application of the principles to the facts in the *Cowan* case was that the union trustees were in breach of their fiduciary duties.

The principles of the *Cowan* case are applicable in Canada. In *Boe* v. a case involving a pension fund, the Supreme Court of British Columbia cited the *Cowan* case with approval and

proceeded to apply general trust law principles to the conduct of the pension fund trustees. In two recent Ontario cases, *Re Reevie and Montreal Trust Co. of Canada* (1986), 53 O.R. (2d) 595 (the "Canada Dry" case) and *Re Collins and Pension Commission of Ontario*, (1986) 56 O.R. (2d) 274 (the "Dominion Stores" case), the courts have accepted without hesitation the position that pension monies are trust monies subject to the general law of trusts. In the Dominion Stores case the Divisional Court imposed a fiduciary duty on the Pension Commission of Ontario. The court held that in consenting to a withdrawal of surplus funds from a pension fund the Commission was dealing with trust funds. The court stated that the Commission was in a fiduciary relationship with the members of the pension plan:

> *While the commission may not, strictly speaking, be a trustee for the members, for it holds no money belonging to the plan, it would be artificial to conclude that the commission's obligation to members is lower than the high standard of fiduciary obligation imposed on trustees. (p. 285)*
>
> and at p. 286:
>
> *My conclusion is that the duty owed by the commission, to both plan employees and Dominion as beneficiaries of the trust, was equivalent to that of a trustee. I have no hesitation in calling it a fiduciary duty; the law knows none higher.*

The result in the Dominion Stores case was that the Commission breached its fiduciary duty by not giving notice to the plan members of Dominion's request for a refund of surplus funds from the pension fund.

The Dominion Stores case is a signpost that shows the clear direction of the courts toward expanding the group of pension fiduciaries. In the case of public sector pension plans, the Treasurer, as custodian of the PSSF, TSF and SAF, and the various ministers and boards responsible for the administration of the plans are fiduciaries with respect to the plan members. As we have seen, the actions of these and other pension plan fiduciaries will be subject to the general law of fiduciaries and the related duty of loyalty and standard of prudence.

The Pension Fund Administrator under the Pension Benefits Act, 1987

As we have noted, the Pension Benefits Act, 1987 (the "PBA") introduces a comprehensive code of fiduciary conduct for administrators of pension plans. Unlike the former law, a plan must be administered by a qualified person before it is accepted for registration (PBA, s. 8(1)). The group of persons eligible to act as administrators includes:

(1) the employer(s);

(2) a pension committee composed of representatives of both the employer and plan members;

(3) a pension committee composed only of representatives of plan members;

(4) an insurance company (if the plan is "insured");

(5) a board of trustees of a multi-employer plan; and

(6) a board, agency or commission given responsibility for the administration of the plan by virtue of legislation

The last category of administrator will have application to statutory public sector pension plans. The Public Service Superannuation Board, the Teachers' Superannuation Commission, the OMERS Board, the Workers' Compensation Board, Ontario Hydro, and the SAF review committees will all be charged with the fiduciary duties imposed by the PBA on pension plan administrators.

The PBA does not prescribe how the plan administrator is to be chosen. Presumably this is a matter for the concerned parties to settle on a case by case basis. For example, if the plan is subject to collective negotiation, that process would likely determine who is to be the administrator.

The PBA establishes a standard of care requiring an administrator to exercise the "care, diligence and skill in the administration of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person" (PBA, s. 23 (1)). The Act further requires an administrator to use all relevant knowledge and skill that he possesses or ought to possess by virtue of his profession, business or calling (PBA, s. 23(2)). The standard of care is thus both objective and subjective at the same time. Conduct will be judged by objective comparison to the person of ordinary prudence. However, a subjective element will bring into play any special knowledge or skill the administrator may, or ought to, have.

The PBA permits an administrator to hire employees and to delegate certain responsibilities to agents (PBA, s. 23(4)). Such hiring and delegation must be reasonable and prudent in the circumstances. The administrator must personally select the agent and be satisfied of the agent's suitability to perform the delegated task. The administrator must supervise the agent to the extent that such supervision is reasonable and prudent (PBA, s 23(5)). Agents and employees of administrators are subject to the standard of care set out above as it applies to the administrator (PBA, s. 23(6)).

From this it follows that investment advisors hired by pension plan administrators are subject to the test of prudence in the PBA. In the case of investment advisors and other agents and employees it is reasonable to expect that the subjective portion of the test requiring the use of relevant knowledge and skill will be particularly critical.

Other provisions of the PBA prohibit conflicts of interest (s. 23(3)) and prevent an administrator from benefiting from his position with respect to the plan (other than fees and expenses and pension benefits in the case of an administrator who is a plan member) (s. 23(7)).

While, the PBA codifies the duties of plan administrators, the guidelines of good conduct set out in the Cowan case will continue to have application to Ontario pension fund administrators.

In addition to the fiduciary conduct rules the PBA imposes numerous administrative duties of a day-to-day nature on plan administrators. These obligations include dissemination of information to plan members, providing notices of amendments, and providing benefit statements to members. These obligations make up the job description of the administrator's position and are separate from the fiduciary standards of conduct.

Summary

The first Canadian pension fund cases concerned with the fiduciary obligations implicit in the pension deal are only now coming before the courts. It is not surprising that the established laws of trust are applied to these fact situations. It should be expected that this approach will become an even more common place occurrence. The Pension Benefits Act, 1987 encourages this development with its code of fiduciary conduct. Pension fund administrators, investment advisors and others in a fiduciary role must recognize that their position carries the heavy burden of the duty of loyalty and the high standard of care of the fiduciary.

July 1987

APPENDIX K

DRAFT REGULATIONS ON PENSION FUND INVESTMENTS

October 30, 1987

PENSION COMMISSION OF ONTARIO

DRAFT INVESTMENT REGULATIONS

1. (1) In this Regulation,

"affiliate" means a corporation that is an affiliate within the meaning of subsection (2);

"book value" means the acquisition cost of an asset of a pension fund, including all direct costs associated with the acquisition, and prior to external financing;

"market value" means the most probable price that would be obtained for property in an arm's length sale in an open market under conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably and willingly;

"mutual fund" means a fund established by a corporation that is duly authorized to operate a fund in which moneys from two or more depositors are accepted for investment and where shares allocated to each depositor serve to establish the proportionate interest at any time of each depositor in the assets of the fund;

"person" includes a corporation and the heirs, executors, administrators or other legal representatives of a person to whom the context can apply according to law;

"pooled fund" has the same meaning as mutual fund;

"real estate corporation" means a corporation which limits its activities to acquiring, disposing of, holding, maintaining, improving, leasing or managing real estate or leaseholds, other than resource property or leaseholds in such resource property;

"real estate fund" means a mutual, pooled or segregated fund the principal object of which is to provide investors with a means of investing in a portfolio of real estate or leaseholds;

"related person" means a related person within the meaning of subsection (3);

"resource corporation" means a corporation which

i) limits its activities to acquiring, holding, exploring, developing, maintaining, improving, managing, operating or disposing of resource properties;

ii) makes no investments other than in resource properties, property to be used in connection with resource properties owned by it, loans secured by resource properties for the exploration or development of such properties or investments that a pension fund or plan is permitted to make under this Regulation; and

iii) borrows money substantially for the purpose of earning income from resource properties;

"resource property" means any property that is

a) a right, licence or privilege to explore for, drill for or take petroleum, natural gas or related hydrocarbons,

b) a right, licence or privilege to

i) store underground petroleum, natural gas or related hydrocarbons, or

ii) prospect, explore, drill or mine for minerals in a mineral resource,

c) an oil or gas well or real property the principal value of which depends on its petroleum or natural gas content, excluding any depreciable property used or to be used in connection with the extraction or removal of petroleum or natural gas therefrom,

d) a real property the principal value of which depends on its mineral resource content, excluding any depreciable property used or to be used in connection with the extraction or removal of minerals therefrom, or

e) a right to or interest in any property described in any of paragraphs (a) to (d);

"security" means any document, instrument or writing commonly known as a security and includes a share of any class or series of shares or a debt obligation of a corporation, a certificate evidencing such a share or debt obligation and a warrant;

"segregated fund" means a fund established by a corporation that is duly authorized to operate a fund in which contributions to be pension plan are deposited and the assets of which are held exclusively for the purposes of that plan alone or that plan and one or more other pension plans;

"traded publicly" means traded on

a) a provincially regulated stock exchange in Canada; or

b) any other market on which securities are traded if the prices at which they have been traded on that market are regularly published in a bona fide newspaper or business or financial publication of general and regular paid circulation;

"voting share" means any share of any class of shares of a corporation carrying voting rights under all circumstances and any share of any class of shares carrying voting rights by reason of the occurrence of any contingency that has occurred and is continuing.

(2) For the purpose of this Regulation,

(a) a corporation shall be deemed to be affiliated with another corporation if one of them is the subsidiary of the other or both are subsidiaries of the same corporation or each of them is controlled by the same person;

(b) the affiliates of every corporation shall be deemed to be affiliated with all other corporations with which the corporation is affiliated;

(c) a corporation shall be deemed to be a subsidiary of another corporation if,

i) it is controlled by,

(a) that other,

(b) that other and one or more corporations each of which is controlled by that other,

(c) two or more corporations each of which is controlled by that other; or

ii) it is a subsidiary within the meaning of subclause (c)(i)(a) of a corporation that is that other's subsidiary;

(d) a corporation shall be deemed to be controlled by a person or persons if,

i) voting shares of the corporation carrying more than 50 percent of the votes for the election of directors are held other than by way of security only by or for the benefit of such person, and

ii) the votes carried by such voting shares are sufficient, if exercised, to elect a majority of the board of directors of the corporation;

(e) a corporation shall be deemed to be the holding corporation of all its subsidiaries;

(f) a person shall be deemed to own voting shares that are owned by another corporation controlled by the person.

(3) For purposes of this regulation, a person shall be deemed to be related to

a) every corporation which the person controls and every affiliate of such corporation;

b) every partner of the person who has substantial beneficial interest in a partnership in which the person has a substantial beneficial interest;

c) every trust or estate in which the person has a substantial beneficial interest or as to which the person serves as trustee or in a similar capacity;

d) the spouse and every child of the person;

e) every relative of the person or of his or her spouse who resides in the same dwelling as the person.

2\. (1) The administrator of a pension plan shall establish and adopt a written statement of investment policies and goals for the plan that complies with the requirements of this regulation and of the Act.

(2) In the establishment and application of the written statement of investment policies and goals, the selecting of investments shall be made with consideration given to the overall context of the investment portfolio, without undue risk of loss or impairment and with a reasonable expectation of fair return or appreciation given the nature of the investment.

(3) The statement of investment policies and goals referred to in subsection (1) shall identify the type of pension plan, and the nature of its liabilities, and shall contain, as a minimum, guidelines addressing:

(a) investment portfolio diversification including aggregate and individual investment limits;

(b) asset mix policy and rate of return expectations;

(c) the categories and sub-categories of investments and loans which may be made;

(d) the policy to be followed where there is an actual or perceived conflict of interest on the part of the administrator, a member of a pension committee, board of trustees or any agency, board or commission acting as the administrator, or any employee or agent of the administrator, including minimum disclosure requirements and the timing of such disclosure;

(e) the lending of cash or securities;

(f) the retention or delegation of voting rights acquired through pension plan investments, and

(g) the basis for the valuation of investments that are not regularly traded.

(4) Subject to subsections 6 and 7, unless investment in a category or sub-category of investment or loan is specifically permitted and guidelines are established in the statement of investment policies and goals, such investments and loans are not permitted.

(5) The statement of investment policies and goals shall be filed by the administrator

a) within 90 days of adoption, and in no case any later than the time periods allowed for the filing of plan amendments as stated in Section 19 of the Act, or

b) in the case of a pension plan established on or after January 1, 1988 within 60 days after the date on which the plan is established.

(6) Until the earlier of the date the statement of investment policies and goals is filed or the date the statement is required to be filed, the pension fund shall be invested in accordance with the investment regulations specified in section 17 of Regulation 746, Revised Regulations of Ontario, 1980 as it existed on December 31, 1987, provided that any new investment made subsequent to January 1, 1988 does not otherwise contravene the requirements of this regulation.

(7) An administrator shall prior to January 1, 1993 bring the plan investments into conformance with this Regulation and the statement of investment policies and goals.

3. (1) The statement of investment policies and goals shall be reviewed by the administrator no less frequently than annually, and confirmed or amended.

(2) All annual confirmations and amendments to the statement of investment policies and goals shall be filed within 90 days of the confirmation or adoption of the amendment.

4. (1) The administrator and any agent of the administrator assuming the responsibility for investing and administering the pension funds shall adhere to the statement of investment policies and goals adopted for the plan.

(2) Subsection 23(4) of the Act does not apply to an employee or agent of an administrator with respect to an investment or transaction to which the employee or agent is a party or has a direct or indirect beneficial interest in the investment or transaction provided,

(a) complete disclosure of the person's interest in the investment or transaction has been given to the administrator prior to entering into the investment transaction, and

(b) the investment or transaction complies with the requirements of the statement of investment policy referred to in section 2.

5. (1) The aggregate amount of a pension fund that shall be invested in the securities of or loaned to any person, partnership or association shall be limited to 10% of the total book value of a pension fund's assets at the time the investment or loan is made.

(2) For the purpose of subsection (1), person includes a related person or group of related persons.

(3) Subsection (1) does not apply to investments in demand deposits with a bank or a loan or trust corporation or a credit union or caisse populaire to the extent such deposits are fully insured by the Canada Deposit Insurance Corporation, the Quebec Deposit Insurance Board or the Ontario Share and Deposit Insurance Corporation.

(4) Where the securities of all of the corporations which are affiliates are not traded publicly, subsection (1) shall apply as if the affiliated corporations were one corporation.

(5) Where the securities of all of the corporations which are affiliates are traded publicly, subsection (1) shall apply on an individual basis to each of the affiliated corporations.

(6) Where affiliated corporations include corporations whose securities are traded publicly as well as those whose securities are not traded publicly,

(a) subsection (1) shall apply on an individual basis to each of the affiliated corporations whose securities are traded publicly; and

(b) subsection (1) shall apply to the affiliated corporations whose securities are not traded publicly as if the affiliated corporations whose securities are not traded publicly were one corporation.

6. Section 5 does not apply to investments in,

(a) pooled, segregated or mutual funds that comply with the requirements of this Regulation;

(b) the shares of a corporation,

(i) whose assets are at least 98 percent cash, investments and loans,

(ii) that does not issue debt obligations,

(iii) that obtains at least 98 percent of its income from investments and loans, and

(iv) which complies with the requirements of this Regulation;

(c) issues, bonds, or debentures of or guaranteed by the Government of Canada or a province or territory of Canada.

7. (1) Investment in real estate or resource properties is limited to,

(a) a maximum of 5% of total book value of pension plan assets directly in any one parcel of real estate or resource property;

(b) a maximum aggregate amount of 15% of total book value of pension plan assets directly in resource properties;

(c) a maximum aggregate amount of 25% of total book value of pension plan assets directly in real estate and resource properties,

at the time the investment is made.

(2) The limits on investment referred to in subsection (1) include any investment in a debenture substantially secured by real estate, or any indirect investment by a pension plan through a real estate fund, or through a real estate or resource corporation which is not traded publicly.

(3) For the purposes of this section, where real property,

i) is subdivided, or

ii) is acquired for consolidation of a parcel,

and thereafter the ultimate beneficial ownership remains the same, the entire parcel shall be treated as one and the investment limits applicable to a single investment applied.

8. (1) A pension fund shall not own more than 30% of the voting shares of any corporation.

(2) The 30% limit referred to in subsection (1) shall not apply to a corporation incorporated for the purpose of and which limits its activities to allowing a pension fund to avail itself of either,

(a) expertise not otherwise available to the fund, or

(b) an investment opportunity in real estate, resource property or venture capital.

9. (1) Except as permitted by section 11, the assets of a pension plan shall not be loaned to, or, except where securities are traded publicly, invested in the securities of

(i) the administrator, or any person on a pension committee, board of trustees or any agency, board or commission acting as the administrator of the pension plan;

(ii) an officer or employee of an administrator of the pension plan;

(iii) a person responsible for holding or investing the pension fund or any officer or employee of such person;

(iv) a trade union representing members of the pension plan or an officer or employee of such trade union;

(v) an employer, other than a Government, or Province or Municipality, who contributes to the plan, an employee of the employer, and where the employer is a corporation, an officer or director of the employer;

(vi) the spouse or child of any person referred to in clauses (i) to (v) inclusive;

(vii) where the employer is a corporation,

(a) any person who directly or indirectly holds more than 10 percent of the voting shares carrying more than 10 percent of the voting rights attached to all voting securities of the corporation or the spouse or child of such person;

(b) any person who directly or indirectly together with a spouse or child holds more than 10 percent of the voting shares carrying more than 10 percent of the voting rights attached to all voting securities of the corporation;

(viii) a corporation which is an affiliate of the employer, or

(ix) a corporation wholly owned or controlled either directly or indirectly by a person referred to in subsections (i) through (vii) above.

(2) Notwithstanding subsection (1), the funds of a pension plan may be loaned to an employee of the employer or the spouse or child of an employee on the security of a mortgage on residential property of such person, providing that the mortgage is guaranteed or insured by or through an agency of the Government of Canada or a province of territory of Canada, or insured by a policy of mortgage insurance issued by an insurance company licensed or registered under the Canadian and British Insurance Companies Act (Canada) or the Foreign Insurance Companies Act (Canada) or similar legislation of any province or territory of Canada.

10. (1) The funds of a pension plan shall not be loaned on the security of a mortgage or hypothec on real estate or leaseholds, where the amount paid for the mortgage or hypothec, together with the amount of indebtedness under any mortgage or hypothec on the real estate or leasehold ranking equally with or superior to the loan exceeds seventy-five percent (75%) of the market value of the real estate or interest therein at the time the advances were approved.

(2) Where the lending on the security of a mortgage or hypothec would exceed seventy-five percent (75%) of the market value referred to in subsection (1), the loan may be made if the amount of the loan in excess of seventy-five percent (75%) of the market value is guaranteed or insured by or through an agency of the Government of Canada or a province or territory of Canada, or insured by a policy of mortgage insurance issued by an insurance company licensed or registered under the Canadian and British Insurance Companies Act (Canada) or the Foreign Insurance Companies Act (Canada) or similar legislation of any province or territory of Canada.

(3) The administrator of a pension plan may, in order to

(a) dispose of real estate owned by the pension fund, or

(b) protect an existing investment of the pension fund,

accept as payment or part payment, or advance funds secured by, a mortgage or hypothec that would otherwise contravene this section.

(4) The funds of a pension plan shall not be invested in second and subsequent mortgages when the sum of the proposed and superior ranking mortgages exceeds the mortgage investment limits specified in either subsection 5(1) or the statement of investment policies and goals.

11. Section 23(4) of the Act does not apply to investment in real estate occupied or to be developed by an employer or Administrator provided,

(i) the conflict-of-interest policy established in the statement of investment policies and goals, and

(ii) all other investment requirements in this Regulation,

are complied with.

12. (1) If, at the end of the fiscal year of a pension plan, the plan has more than 50 members or $1,000,000.00 in assets calculated at market value, the administrator shall file with the Pension Commission financial statements for the pension fund together with an auditor's report respecting the financial statements.

(2) The auditor's report referred to in subsection (1) shall be prepared by an accountant.

(3) The financial statements referred to in subsection (1) shall be filed within six months following the fiscal year end of the pension plan.

(4) The financial statements referred to in subsection (1) shall be prepared in accordance with generally accepted accounting principles.

(5) The auditor's report referred to in subsection (1), shall be prepared in accordance with generally accepted auditing standards.

(6) When a recommendation has been made in the Handbook of the Canadian Institute of Chartered Accountants, as amended from time to time, which is applicable in the circumstances, the terms "generally accepted accounting principles", "auditor's report" and "generally accepted auditing standards" mean the principles, report and standards, respectively, recommended in the Handbook.

(7) Notwithstanding anything contained in this regulation, it is not necessary to disclose in the financial statements any matter that in all the circumstances is of relative insignificance.

(8) The financial statements referred to in subsection (1) shall at a minimum disclose:

(a) the market value and carrying value of each major category of investments at the beginning and end of the period;

(b) investment income;

(c) current period changes in market value of total investments;

(d) contributions from employer(s);

(e) contributions from members;

(f) administrative expenses;

(g) benefit payments, and

(h) refunds and transfers.

(9) The auditor shall report to the administrator whenever he or she becomes aware that there are circumstances that indicate that there has or may have been a contravention of this part.

(10) The auditor shall make a report under subsection (7) immediately upon becoming aware of a circumstance described in that subsection.

(11) The auditor shall report to the Superintendent any matter reported under subsection (9) which in the opinion of the auditor might reasonably be expected to affect the well-being of the pension plan and which, in his or her opinion, has not been corrected or appropriately responded to by the administrator within thirty days of the date that the matter was first reported to the administrator.

(12) An auditor is not required to make a report under subsections (9) and (10) unless the auditor becomes aware of a circumstance described in subsection (9) in the course of his or her duties as auditor.

13. (1) The administrator of a pension plan may lend the investments of the pension fund provided,

(a) such lending is permitted in the statement of investment policies and goals referred to in section 2, and

(b) the loans are secured by cash or readily marketable investments having a market value of at least 105% of the loan and maintained no less frequently than weekly at a market value of at least 105% of the outstanding market value of loaned assets.

14. The administrator of a pension plan shall not borrow for the pension fund except where,

    (a) the borrowing is necessary to cover short term contingencies; and

    (b) the borrowing is restricted to a term not exceeding 90 days.

15. All investments and loans of a pension fund shall be held in the name of, or for the account of, the fund.

16. Fully-insured contracts and deposit administration general funds contracts which are regulated by the Canadian and British Insurance Companies Act (Canada) or comparable provincial law shall be exempted from the application of this Regulation.

17. Unless otherwise permitted by this regulation, a pension plan shall not directly or indirectly pledge, mortgage or hypothecate the assets of the pension fund.

18. Where a pension fund owns investments of a corporation and as a result of a bona fide arrangement for the reorganization or liquidation of the corporation or for the amalgamation of the corporation with another corporation, such investments are to be exchanged for bonds, debentures or other evidences of indebtedness, or shares which result in the limitations set out in this regulation being exceeded, the pension fund may accept and hold such bonds, debentures or other evidences of indebtedness or shares.

APPENDIX L

PRUDENCE AND PENSION FUND INVESTMENT MANAGEMENT

By Keith P. Ambachtsheer, Keith P. Ambachtsher & Associates

Paper Purpose and Conclusions

Discussion Paper Purpose

While the concept of 'prudence' has always been considered a behavioral guide in the management of pension funds, it has taken on added significance recently. This is so because it is about to be enshrined in Canada's federal and provincial pension regulations as **the** guiding principle for persons who are in decision-making positions regarding the disposition of pension fund assets.

Such persons could have any one of a number of specifically defined responsibilities with respect to the pension fund. They could be members of the committee responsible for the overall administration of the pension plan, including investment policy. They could also be investment managers hired by the administrative committee to implement investment policy. Throughout this paper we refer to both policy makers and policy implementors as 'fund fiduciaries.'

How are fund fiduciaries 'prudent' (or conversely, 'imprudent') when making decisions regarding the disposition of pension assets? What role should regulators play in defining and assessing prudence? It is these central question this paper addresses.

This paper uses the Ezra paper *The Nature of the Pension Agreement*, May 20, 1987 pension 'deal' categorization as part of its framework. Thus pension 'deals' are asset-based, defined-benefit based, or partially asset/partially defined benefit-based. In other words, pensions are based on the accumulated value of pension assets, are defined independent of the value of pension assets, or are based on some blend of asset value and defined benefits.

Paper Conclusions

- pension fund fiduciaries have the general obligations to act in the best interest of the fund (rather than their own) and to be 'evenhanded' when there is more than one beneficiary
- beyond these general obligations, 'prudence' as it relates to pension fund fiduciaries only has meaning within the economic context of a specific 'pension deal' and a specific pension plan
- this implies a fund fiduciary's first obligation is to understand the pension deal behind any specific pension fund, such an understanding is needed to set the fund investment policy
- while the fund fiduciary's responsibilities in asset-based pension deals is straight-forward (with the interests of plan members being the sole focus), they are more complicated in defined benefit-based deals
- 'prudence' involving defined benefit-based deals requires sorting out the respective financial interests of plan members and the plan sponsor/employer in the pension fund . . . and these interests are akin to those of bond holders and equity holders respectively in a normal enterprise
- 'investment policy prudence' focuses on the translation of:

  (a) the pension deal,

  (b) the risk tolerance of the stakeholders in the deal, and

  (c) an assessment of long term capital market prospects, into a long term asset mix policy for the fund and who is to implement it

- beyond 'investment policy prudence,' there is 'investment management prudence,' which deals more specifically with the prudent day-to-day investment management of the fund
- the appropriate focus for 'investment management prudence' is investment skill . . . and the investment process such skill leads to
- the recently proposed PCO pension investment regulations have moved some distance away from prescribing the appropriateness of individual investments in pension funds based on quality and quantity tests, which is the focus of the current regulations
- however, a good deal of the old emphasis on prescribing acceptable investment behaviour (i.e.. investment management prudence) remains, although much of it now has shifted to the portfolio level

  the PCO proposals are virtually silent on the issue of 'investment policy prudence,' which should be the focal point of a prudence-based regulatory environment
- we attribute this silence to the prevailing atmosphere of ambiguity and confusion surrounding the nature of existing pension deals between employers and employees (current and former) in the Province

Understanding Prudence

Definitions of 'Prudence'

The focus for 'prudence' in this paper is appropriate standards of conduct for those administering pension funds. Until recently, no pension fund-specific wording had been fashioned. The most-often quoted historical standard was the classical 1830 Harvard College vs. Amory court decision:

> *. . . All that can be reasonably required of a trustee to invest is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of capital to be invested . . .*

Nineteenth century British rulings read much the same way but tended to make a distinction between the management of one's own property and that of others. Their bias was to make the test based on how one would deal with the property of another person.

For the purposes of the USA Employee Retirement Income Security Act (ERISA) of 1974, the prudence standard was updated to read:

> *. . . with the care, diligence, and skill, under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . .*

The key change in this new version would seem to be that a pension fund fiduciary is not just a person of "prudence, discretion, and intelligence," but also someone who has specific understanding of and/or skills in the management of pension funds.

In its April 13, 1987 proposed regulations the Pension Commission of Ontario set the following 'prudence' standard (derived from Bill 170, Sections 23.1 and 23.2):

> *. . . the exercise of care, diligence and skill in the investment and administration of fund assets that a person of ordinary prudence shall exercise in dealing with the property of another person using all relevant knowledge and skill that a person by his or her profession, business or calling ought to possess . . .*

ERISA vs. PCO Prudence Standards: Difference in Substance?

While the new Ontario standard reads much like the ERISA standard, there would appear to be a subtle difference. ERISA says plan fiduciaries **have to have** specific skill. The PCO document appears to only demand the use of specific skill **if the person has it or ought to have it.**

Is the difference between the ERISA and PCO 'prudence' standards real or do they in fact amount to the same thing? I believe they in fact amount to the same thing. I can not picture an Ontario court accepting a defence that a fund fiduciary who had no knowledge or skill related to pension fund investments could never be imprudent simply because he or she had no knowledge or skill. If such a person made material decisions regarding the disposition of pension assets **without the involvement of persons who did have such knowledge or skill**, such action would surely be judged as imprudent!

Pension Fund Fiduciaries: Who Are They?

Legal opinion has it that the general concept of a "fiduciary" under the law is a rather vague one. Author J.C. Shepherd in *The Law of Fiduciaries* offers the following definition:

> *. . . a fiduciary relationship exists whenever any person acquires a power of any type on condition that he/she also receive it with a duty to utilize that power in the best interests of another, and the recipient of that power uses that power . . .*

So not only are legal trustees fiduciaries, but so are company directors, politicians, brokers, lawyers, doctors, and even employees.

Where a fiduciary has investment-related responsibilities, and more specifically, has trustee powers, three general duties are implied:

1. Responsibilities may not be delegated unless explicitly permitted by the trust document.
2. A trustee may not benefit personally from his/her position as trustee.
3. A trustee must treat all beneficiaries evenhandedly.

These 3 general duties take pension fund fiduciaries some way as behavioral yardsticks. They are the basis, for example, in the famous British Cowan v. Scargill pension fund trustee court judgement. In it, the Court of Queen's Bench noted the obligation of trustees to be evenhanded to act in the sole interests of present and future trust beneficiaries, and "to seek advice on matters the trustee does not understand."

More specific duties follow from the specific circumstances of a given fiduciary or trust situation. For example, we saw both ERISA and PCO pension fund fiducairy standards refer to "familiar with such matters" and "using all relevant knowledge or skill. . ."

What neither the ERISA or PCO standards address explicitly is the acceptable level of "familiarity, knowledge or skill" related to pension funds as part of the pension fund 'prudence' standard. It is this question the paper goes on to pursue. In so doing, the paper also addresses the related question of prudence assessment.

Key Assumption: Economic Prudence will Define Legal Prudence

In what follows we assume that economic prudence will define legal prudence. In other words, in judging prudence or imprudence on the part of fund fiduciaries we assume courts would base their decisions on the economic logic of the arguments presented and not on specific definitions of prudence (beyond the 3 general duties listed above) assumed to be relevant regardless of a specific situation.

To explain further, prudence or imprudence by fund fiduciaries only takes on meaning in specific economic contexts: what might be a prudent decisions in one pension fund context could well be an imprudent decision in another.

We take our specific economic contexts from the May 20, 1987 paper titled *The Nature of the Pension Agreement* by Don Ezra. Ezra defines 6 possible types of pension 'deals' between employers and pension plan members (by 'deal' we mean the specific terms and conditions of the pension agreement between the two parties). Each of these 'deals' can be a fair and equitable component of an employer/employee total compensation arrangement. Each has very specific implications for what constitutes prudent behaviour by pension fund fiduciaries.

An implication common to all 6 types of arrangements is that **fund fiduciaries must understand what the pension deal is.** This is so because the key investment policy decision for a pension fund is its asset mix policy. Making prudent asset mix policy decisions requires understanding who the stakeholders are in the pension 'deal'. More specifically, it requires understanding who bears the risk and garners the reward of bad/good investment results. And it requires knowing what risk tolerance the risk bearer(s) has(have).

A further implication is that it is appropriate to have different criteria for judging prudent behaviour for different fund fiduciaries, depending on their specific role in the management and administration of the pension fund. The next section of the paper titled *Prudence and Investment Policy* develops these ideas further.

Prudence and Investment Policy

Pension 'Deals' and Investment Risk and Reward

Ezra points out that pension 'deals' can be asset-based, liability defined benefit-based, or partially asset/partially defined benefit-based.

If the pension deal is asset-based, the plan member has a very direct interest in asset mix policy. This is so because ultimate pension benefits will be based on the performance of the fund assets held on behalf of that plan member. In this case, any pension fund decisions made by the fiduciaries are made directly on behalf of plan members. It is **plan members** who bear the risks and garner the rewards of bad/good investment results.

So prudence by fund fiduciaries in the asset-based 'deal' case must be judged in the context of how well investment policy decisions and their implementation were intended to serve the economic interests of pension plan members directly. An important measure of prudence here would be the efforts taken by the fund fiduciaries to ensure each plan member can align his/her asset mix with his/her own financial planning and attitude towards bearing investment risk.

If the pension 'deal' is defined benefit-based, fund fiduciaries face a materially different economic situation. The pension plan sponsor now issues the equivalent of pension promissory notes to its employees. Now the economic rationale for the pension fund is to serve as a backup 'solvency' vehicle to secure the promissory notes already issued.

So prudence in the defined benefit-based 'deal' case must first and foremost be judged in a plan solvency (i.e. 'benefit security') context. This implies prudence in the first instance can only be exercised through the assessment of the pension plan balance sheet. Generally, prudent pension fund decisions imply they have been evaluated in the context of their likely impact on the solvency (i.e.. benefit security) of the pension plan.

The Plan Sponsor's Financial Interest in the Pension Fund in Defined Benefit–Based Pension 'Deals': A Complication

There are two factors fund fiduciaries should consider in making their plan solvency evaluation:

1. The financial strength of the plan sponsor.
2. The size of the pension fund in relation to the estimated size of pension liability.

Clearly, the greater the financial strength of the plan sponsor, the lower the risk that pension promises will not be kept. Also, the greater the size of the pension fund in relation to

the estimated size of the pension liability, the lower the risk pension promises will not be kept.

But things are not this simple for fund fiduciaries. Why? Because there are higher risk investment policies which, over the long run, will likely produce higher fund returns. And there are lower risk investment policies which, over the long run, will likely produce lower fund returns.

By definition in defined benefit-based pension 'deals,' plan members are only affected by the investment policy chosen to the degree this policy affects the solvency risk of the plan. In cases where (1) the plan sponsor is financially strong, and (2) the plan balance sheet is strong, the investment policy chosen will, within reasonable bounds, have little impact on plan solvency. In this case, on what basis do fund fiduciaries choose an appropriate fund asset mix policy?

Logically, they should look at the financial impact of differing fund investment policies on the plan sponsor. Higher risk policies will, over the long run, through higher rates of return, reduce the contributions required by the employer to maintain the plan. But, of course, such policies could also **increase** the required employer contribution rate when capital markets falter. Out of such an evaluation could come any one of a number of investment policy decisions appropriate to a specific pension plan situation . . . ranging all the way from return maximizing at one extreme, to risk minimizing at the other.

In summary, liability-based pension deals require prudent fund fiduciaries to look at the financial interests of **both** plan members and the plan sponsor. The plan member's financial interest is that of a promissory note holder, with the pension fund acting as security that pension debt will be paid. The plan sponsor's financial interest is that of an equity holder, with pension fund performance either adding to, or subtracting from its financial wealth.

Author's note: the current Ontario controversy regarding 'surplus' ownership can be seen as part of a public debate as to whether pure defined benefit pension 'deals' should be permitted as a matter of public policy . . . or whether all defined benefit pension 'deals' between employers and employees have to have (or in a retroactive sense, have had to have) at least some asset-side participation by plan members.)

Combination Pension 'Deals'

With pension deals where plan members and the plan sponsor explicitly share pension fund risks and rewards, it is incumbent upon fund fiduciaries to understand the specific nature of the risk sharing arrangement. Now, for example, plan members might be the equivalent of 'participating' promissory note holders. That is, they continue to expect benefit payments based on a specific formula, but that formula might occasionally adjusted, based on the performance of the pension fund. Alternatively, contribution rates (including that of active plan members) required to support a given benefit formula might be occasionally adjusted, based in the performance of the pension fund. From this understanding, and from some process where the risk tolerances of the stakeholders are properly brought into play, fund fiduciaries decide and implement investment policy.

Author's note: some observers argue that **all** pension deals involve risk sharing, if not explicitly, then implicitly between the plan sponsor and plan members. Pension deals with "implicit" components would make life very difficult for pension fund fiduciaries. How are they to figure out the respective financial interests of the plan members and the sponsor (ultimately either taxpayers or shareholders) in the fund? Where there is no agreement, they might well force any dispute to be settled **before** they assumed any fiduciary responsibilities. Without such settlement, they might be leaving themselves open to suit by one party to the dispute or the other.)

Investment Policy Decision Assessment Procedures

Whether pension 'deals' are asset-based, defined benefit-based, or combination-based, plan fiduciaries should follow certain steps if prudent pension fund investment policy decisions are to be made:

1. Understand the pension 'deal.'
2. Decide what investment horizon(s) is(are) most appropriate to the situation.
3. Obtain defensible risk/return projections (and their interdependences) for the eligible asset classes, inflation, and pension debt over the investment horizon(s).
4. Evaluate the riskiness of a number of investment policy alternatives in the risk dimension(s) most relevant to the particular investment situation (i.e.. contribution rate variability, plan surplus variability, final pension variability) and weigh them against their expected long term payoff.
5. Decide which of the alternatives is most likely to be the most appropriate investment policy alternative out of the available choices. As part of that decision, the risk tolerance(s) of the investment risk bearer(s) (i.e.. plan members, tax payers, and/or share-holders) and other relevant considerations such as the demographic characteristics of plan membership, the likelihood of plan termination, etc. should be taken into account.
6. Evaluate alternative **policy implementation** alternatives in terms of their reliability and cost-effectiveness.
7. Decide which of the implementation alternatives is likely to be most appropriate to the situation.
8. Review the continued appropriateness of all policy decisions and their mode of implementation regularly (probably at least annually).

The documentation of these steps and the decisions they led to is an important part of the process. An ongoing monitoring process as to pension fund management effectiveness is an essential component of exercising policy prudence. Such a process should, at a minimum, have the following attributes.

- a regular breakdown of total fund return realizations into risk-free asset mix policy-related, and investment management-related components
- an evaluation of the asset mix policy-related fund component against long term capital market and inflation expectations
- an evaluation of the investment management-related fund return components against the returns of pre-determined capital market benchmarks
- a qualitative assessment as to whether the original assumptions that led to the chosen asset mix policy and investment management structure continue to be valid (it follows that if this assessment leads to a "no" conclusion, the policy fiduciaries have a responsibility to take action to remedy the situation)

The Ontario Public Sector Situation

It is my assessment that not enough 'policy prudence' thinking along the lines outlined in this paper has taken place among either regulators or fund fiduciaries in Canada (or the USA for that matter). And the Ontario public sector is no different . . . except that there now is a Task Force looking at the question.

The Ontario Government is indirectly affecting 'policy prudence' considerations through the Pension Benefits Act, 1987. Many of the items in this Act affect the terms and conditions "pension promissory notes" must carry in the future (e.g.. the vesting-portability provisions).

A special Inflation Protection Task Force is looking at the question of whether the 'notes' must be inflation-indexed. The current surplus withdrawal moratorium (already mentioned above)

directly affects the financial position of plan sponsors in defined benefit plans registered in the Province.

All these actions impact on the nature of the 'pension deal' and hence bear close watching by plan fiduciaries.

We now go on to examine prudence in the context of investment policy **implementation**,that is, the actual investment management function.

Prudence and the Implementation of Investment Policy

From Policy Making to its Implementation Through Investment Management

We have made a conscious distinction between investment policy making and its implementation. It is our view that policy implementation through investment management requires specific training and experience which policy making fund fiduciaries do not necessarily (or even likely) have.

Such specific training and experience (which eventually became 'skill') could relate to any one of a number of investment specialties. Today's pension funds do not only invest in domestic stocks and bonds. They also invest in foreign securities, real estate, venture capital, and a host of derivative investments such as options and futures.

Generally, it seems to us that persons making pension fund investments in any of these asset classes without the guidance of training and experience (and the disciplined investment process such training and experience instills) could well be judged acting imprudently.

Standards of Investment Management Prudence: USA vs. Canada

Interestingly, both the 1974 USA and the new Canadian pension investment standards say more about 'investment management prudence' than they do about what we have called 'investment policy prudence.' But regulators in the two countries are not of totally similar minds when it comes to actually dealing with implementation prudence.

Beyond requiring training and experience, USA pension fund investment prudence standards provide one more important piece of implementation guidance. And that is that prudence would require consideration of such factors as portfolio diversification and plan liquidity requirements.

Further, risk alone does not render an investment prudent or imprudent per se. Any investment should be analysed as to what risk and return it contributes **to the total portfolio.**

The PCO in its April 13, 1987 document also focuses on risk at the total portfolio level.

It mentions for example, "to control the diversification of plan portfolios . . ." as one of its regulatory objectives.

But it goes well beyond the USA standard in the sense that it then proceeds to define what it deems to be minimum diversification standards: pension funds are to have no more than 5 per cent of assets in a single resource or real estate investment . . . no more than 10 per cent of assets in other single investments. Pension funds are to have no more than 15 per cent of the fund in resource investments . . . etc.

Statement of Goals and Objectives

The PCO requires a written Statement of Goals and Objectives "which will meet the Prudent Person test." This Statement is to "contain as a minimum specific criteria related to diversification of investments, asset mix, and investment quality and quantity tests." There seems to be an expectation that such a Statement would go beyond the investment restrictions already placed on the investment manager through the Regulations themselves.

Ironically, one way the Regulations are being liberalized is through the removal of investment quality tests currently part of the Pension Benefits Act. Yet, it appears fund fiduciaries are going to be forced to write such restrictions back into their own Statement (why else would the statement have to list specific "investment quality tests?"). It would seem Canadian pension fund regulators are still hung up on single investment (as opposed to 'portfolio') despite their claims to the contrary.

In a prudence-driven regulatory environment, regulators have no business requiring fund fiduciaries to articulate quality tests at the individual investment level. Indeed, they logically have no business telling fund fiduciaries specifically **how to** (as opposed to simply **to**) diversify at the portfolio level.

Regulators **do** have an obligation to remind fund fiduciaries that they must deal prudently with the establishment of an investment policy appropriate to the specific nature of a given pension 'deal'. Ironically, the PCO document is virtually silent on this latter topic.

Only significant progress on the clarification of legitimate, fair 'pension deals' between employers and employees is likely to have any material impact on this continued imbalance in regulatory emphasis (too little emphasis on 'policy prudence' and too much on 'investment management prudence'). The Task Force has an opportunity to play a major role in this much needed 'deal' clarification process . . . and in redressing the continued (although decreasing) imbalance in Canadian regulatory 'prudence' emphasis.

Note: This appendix was written in June 1987 in light of an early draft of the investment regulations under the Pension Benefits Act, 1987. A near-final draft of the investment regulations is reproduced in Appendix K.

APPENDIX M

REPORTING ON PUBLIC SECTOR PENSION FUNDS

Introduction

The purpose of this appendix is:

- to provide a summary of the kinds of financial information now provided by the seven funds listed in our terms of reference, and
- to identify the minimum financial information which we believe should be provided by a large pension plan to its members and (if a public sector plan) to the taxpaying public.

Information on a pension plan's financial status is important to many stakeholders, but particularly to plan beneficiaries. The individual member or pensioner needs this information to assess the fund's ability to pay benefits when due. Taxpayers likewise need an appreciation of the financial health of public sector funds, since they are usually responsible for any deficits. Financial information also serves as a method by which the pension fund fiduciaries are held accountable.

The reporting requirements of the Pension Benefits Act, 1987 establish a legal minimum. Many plans and funds already provide financial information direct to plan members or in reports filed publicly.

Financial Information Now Reported

Figure 1 sets out the kinds of financial information provided for the seven large public sector pension funds in our terms of reference.

Financial Information Provided by Seven Large Public Sector Pension Funds – 1986

Financial information	FUND							
	TSF	PSSF	SAF		OMERS	HYDRO	HOOPP	WCB
			PSSAF	TSAF				
Balance Sheet/ Financial Statements	✔	✔	✔	✔	✔	✔	✔	✔
Investment Program/ Statement of Long-Term Investments	✔				✔	✔		
Summary of Financial Highlights					✔	✔		
Cash Flow Data	✔			✔	✔	✔	✔	✔
Financial Information sent directly to plan members	✔			✔	✔	✔		

FIGURE 1

A balance sheet and financial statement is published for all seven large pension funds. The balance sheet shows the fund's assets and liabilities at the end of the fiscal year, and the financial statement outlines the revenues and costs of the fund for the fiscal year.

The Teachers' Superannuation Commission prepares statements and other financial information on the Teachers' Superannuation Fund (TSF) and the Teachers' Superannuation Adjustment Fund (TSAF) for its members. Public Service Superannuation Fund (PSSF) and Superannuation Adjustment Fund (SAF) financial data is assembled and published by the Ministry of Treasury and Economics in the Provincial Accounts. The statements for the other four funds are provided by OMERS, Ontario Hydro, the Ontario Hospital Association (OHA) for the Hospitals of Ontario Pension Plan (HOOPP), and by the Workers' Compensation Board (WCB).

The reports on the TSF, OMERS and Ontario Hydro only provide a balance sheet and a financial statement. Both OMERS and Hydro outline their fund's investment program and the financial highlights for the past year. This includes a general discussion on the fund's asset mix and the investment strategy adopted by the pension fund governors. The TSF report does not go into as much detail as OMERS and Hydro, but it does list the funds' long-term investments.

The majority of the plans provide cash flow data although several different terms are used:

TSF	Statement of Changes
HYDRO	Statement of Changes
OMERS	Statement of Reserves
HOOPP	Statement of Continuity of Fund
WCB	Statement of Transactions
TSAF	Current Cash Flow Projections

These statements simply summarize the increases (contributions plus investment income), less the decreases (expenditures).

Cash flow data are not published for the PSSF or the SAF.

While all seven funds publish financial information, only the TSF and HYDRO reports are sent direct to the members. OMERS provides copies of its report to employers for distribution to members.

The WCB publishes its pension fund's balance sheet and statement of transactions in the Board's Annual Report, which is available on request.

In addition to the statements in the published provincial accounts, financial statements for the PSSF and the PSSAF are reported every spring in the internal public service newspaper, Topical.

The OHA sends copies of its annual report on HOOPP to member hospitals to post on employee bulletin boards.

Minimum Level of Financial Reporting for Large Pension Funds

The Pension Benefits Act, 1987 and its regulations will require administrators of pension plans and funds to make certain information available on request to plan members and their representatives. This includes a statement of investment policy and goals established for the pension fund, and an audited financial statement for the pension fund filed with the Pension Commission of Ontario.

In addition to this minimum standard, the Task Force believes that information should be provided to help plan members and taxpayers (and their representatives) assess the investment performance of the pension fund in relation to the approved investment policy. It

also would be appropriate to provide information on the composition and roles of decision-making and advisory bodies, and external investment managers.

Conclusion

Enclosed, as part of this Appendix, is a copy of the 1986 OMERS annual report. OMERS provides most of the information we consider the various stakeholders need, at a minimum, in order to form judgements on the performance and financial status of a fund.

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT SYSTEM

Established almost 25 years ago by an Act of the Ontario Legislature, the Ontario Municipal Employees Retirement System is a pension fund serving a diversified membership of employees of local government.

In addition to 1,069 municipalities, local boards and schoolboards, OMERS also manages the pension plans of Ryerson Polytechnical Institute and the Colleges of Applied Arts and Technology on a management fee basis.

OMERS is financed by equal contributions from member municipalities and their employees. To meet its obligations to present and future members, OMERS must invest their funds and reinvest the returns prudently and effectively.

OMERS is a contributory defined benefit plan, but ad hoc increases and improvements to retirement benefits have been made over the years without any increase in member and employer contribution levels. These improvements to the pension benefits were made possible by sound and stable financial planning and because of the strong investment performance of the OMERS fund.

OMERS' fund currently is invested in a widely diversified portfolio of capital market investments including equities, bonds, short-term money market securities, mortgages, real estate, term loans and venture capital.

OMERS is managed by a Board whose eleven members are appointed by the Lieutenant Governor in Council on the recommendation of the Treasurer of Ontario. The Board is unique to the pension world with the majority of the members of the Board being employees of local governments contributing to the plan. Other members are elected or appointed officials of municipalities and local boards of municipalities. Thus OMERS is managed by and for local government employees and employers with the sole and dedicated purpose of providing an appropriate and uniform retirement income at stable and reasonable contribution rates.

About the cover
The new building at One University Avenue in Toronto, where OMERS' offices are now located

Pour obtenir un exemplaire en français de ce rapport, écrire à:

OMERS
1, University Avenue, Bureau 1000
Toronto (Ontario) M5J 2P1
(416) 369-2400

CONTENTS

CHAIRMAN'S REPORT

We are pleased to report that a strong performance by OMERS in 1986 has maintained and built upon the sound financial position of the pension fund. This position enables OMERS to perform its fundamental function — the provision of pension benefits to present and future members. According to the actuaries' report, OMERS is well placed to meet its obligations for the foreseeable future.

During the year, OMERS obligations increased as the number of contributing members grew to 140,120 from 135,098 in 1985 and the number of pensioners rose to 33,340 from 30,881.

Pension contributions of $462 million showed little change from the previous year. OMERS' contribution rates are integrated with Canada Pension Plan contributions and are based on 7% of the salary of individual members (1% more for members with a normal retirement age of 60) with equal member and employer contributions.

For the third consecutive year, investment income outstripped pension contributions. At $819 million, investment income was up by 26% from the $651 million earned in 1985. By industry standards, OMERS' return has been consistently above average. For the past five years, the average rate of return on the fund was 19% per annum, compared to the SEI Comparative Measurement Service median return of 17.4%.

Due to the level of return achieved over the years, and to sound financial planning, OMERS has been able to make steady improvements to retirement benefits. In 1986, pensions were raised by 6½% — the largest increase since 1975.

Furthermore, we have introduced a "rule of 85" for members with a normal retiring age of 60 — permitting them to retire early if their age, combined with years of service, reaches 85 years. This brings these members in line with those who have a normal retiring age of 65 and are eligible to apply for the rule of 90.

The market value of the pension fund investments has grown substantially in recent years. By the end of 1986, the market value was $8.2 billion, compared to just under $7 billion in 1985.

In little over two decades, OMERS has grown to become one of the largest pension funds in Canada. But the rapid growth has not been at the expense of prudent business principles. We constantly review policies and set goals to ensure that the investments are well balanced and diversified — to protect against downturns within regions and industry groups. Again in 1986 we made strides towards these goals.

While the strength and performance of the fund — and the efficient administration of pensions — are our primary concerns, the Board of Directors is also very conscious of OMERS' role as a responsible corporate citizen.

We are therefore proud of the significant contribution that OMERS has made to Ontario and Canada over the years through sound investments that have helped stimulate economic growth, create employment, finance business expansions and support small business.

In 1986, OMERS' impressive record in this area was upheld. To single out just one of many important investments in Ontario during the year, OMERS completed Constitution Square in Ottawa — a major real estate development project that has helped revitalize the city's downtown core.

One other real estate project warrants special mention: in 1986, OMERS purchased and completed a new office tower at One University Avenue in Toronto — a building that now houses our head office along with a number of other tenants. From this new vantage point, the people at OMERS look forward to another year of serving our membership.

On behalf of the Board,

C.M. Beckstead

C.M. Beckstead, Chairman
April 24, 1987

1986 IN REVIEW

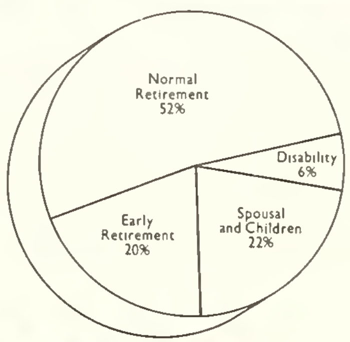
PENSION PROGRAM

In 1986, OMERS paid out a total of $133.5 million in pensions — up 24% over the previous year.

By the end of the year, the system included 33,340 pensioners, an increase of 8%. This reflects steady growth in the number of pensioners in the past decade.

During 1986, the recipients of pension benefits fell into 4 basic categories, as follows:

1986 PENSION PROFILE



The payments actually made to pensioners during a given year form just one part of OMERS' obligations. The strength of the fund is judged by its ability to meet *future* obligations.

We must therefore look at the future requirements of 140,120 current contributing members of different ages, retiring at different times. These are the factors that actuaries look at when they make their valuation reports.

The latest actuarial evaluation, prepared last year by The Wyatt Company, indicates that OMERS is in sound financial condition and that current member and employer contribution rates appear sufficient to fund future benefits.

In preparing the valuation, actuaries assumed salary increases averaging 6% a year, and fund earnings of 7% a year to the retirement of a member and 6% thereafter. The actuaries also assumed annual increases of 5% on the maximum pensionable earnings used under the Canada Pension Plan — which is $25,900 in 1987.

($ Millions)	Actuarial valuation results As at January 1	
Actuarial liabilities	1986	1985
Present value of		
Pensions under payment	$1,186.9	$ 969 3
Vested deferred benefits	34 3	32 1
Benefits for present contributors and their survivors	4,172 4	3,750 6
Additional voluntary contribution liability	.7	7
Total liabilities	5,394 3	4,752.7
*Fund assets at January 1	5,962.9	4,980.0
Funding Excess	$ 568.6	$ 227 3

*As valued by the actuary

In calculating actuarial assets (which include only OMERS' fund and not the other plans under management), most investments are carried at book value. However, investments in common shares and real estate are carried at book value plus a calculated portion of unrealized appreciation (or depreciation) to reflect long-term trends. This process averages market values for these investments over a five-year period, thereby smoothing out the effect of market volatility.

Particularly significant in 1986 was the funding excess of $568.6 million. Over the years, OMERS'

Participants in the System

EMPLOYERS

At the end of 1986, there were 507 municipalities, 132 school boards and 430 other local boards participating in OMERS for a total of 1,069 participating employers — an increase of 6 employers.

OMERS represents a pooling of large and small municipal employers. More than half of the participating employers have fewer than 25 employees who are members of the system and for these the average is 9 members each. At the other extreme, 59% of the membership is employed by 63 employers with an average of 1,313 members each

CONTRIBUTING MEMBERS

In the past decade, OMERS' membership has increased from 106,030 to 140,120.

Membership activity in 1986 was as follows:

Contributing members, January 1, 1986		135,098
Members enrolled during 1986		15,342
		150,440
Less: terminations, transfers, disabled and deaths	7,592	
retirements	2,728	
		10,320
Contributing members, December 31, 1986		140,120

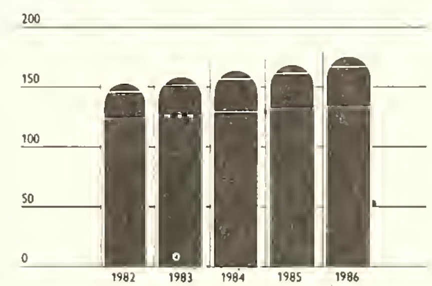
In 1986, over half of OMERS' members were employees of municipalities, one quarter were employees of school boards and the remainder were employees of other local boards. Two out of every five members were female and one in eight members was a policeman or fireman with a normal retirement age of 60 years.

PENSIONERS

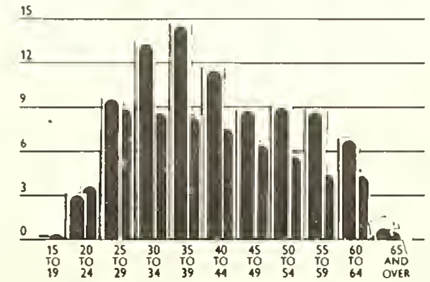
The number of pensioners continued to grow, as follows:

Pensioners, January 1, 1986		30,881
Additions during the year		3,582
Deletions:		
death of pensioners	1,090	
other causes	33	
		1,123
Pensioners, December 31, 1986		33,340

NUMBER OF PARTICIPANTS
(Thousands)
Deferred Vesteds ■ Pensioners ■ Actives

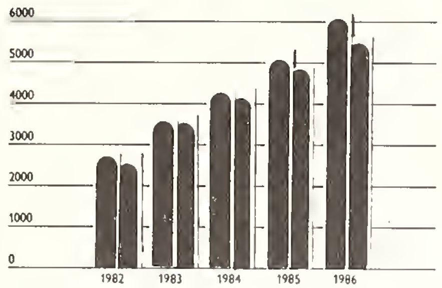


MEMBER CLASSIFICATION BY AGE GROUPING
(Thousands)
Males ■ Females



actuarial assets have matched or exceeded the minimum liabilities (or funding requirements) established by the actuaries.

ACTUARIAL ASSETS VS MINIMUM LIABILITIES
($ millions)
■ Actuarial Assets ■ Minimum Liabilities



Assets exceeded minimum funding liabilities by a wider margin in 1986, leaving OMERS in a strong position to respond to potential changes in the pension environment.

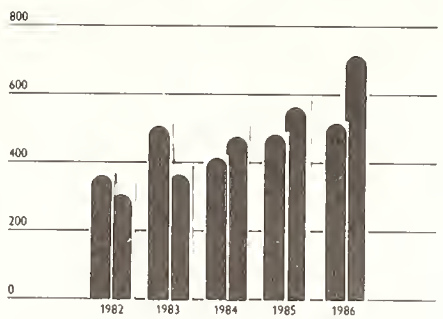
The funding excesses, sparked in recent years by an unusually high level of activity in global capital markets, have allowed for regular improvements to benefits. Since 1980, basic benefits have increased 4.3% annually, on average, while spousal benefits have been strengthened and made more equitable and early retirement provisions have been expanded. In 1986 alone, pensions were raised by 6½% and a "rule of 85" was introduced, as mentioned in the Chairman's Report.

A healthy safety margin is more important now – during this era of pension reform – than ever before. New funding requirements may well emerge with the upcoming Pension Benefits Act, and indexing for existing and future pensioners may become law. The cost of these may, in fact, be greater than the current excess, and so we will continue to strive to achieve a high level of returns – to protect against increases in contribution rates.

INVESTMENT PROGRAM

OMERS' investment performance has fuelled the growth of the pension fund in recent years. In fact, beginning with 1984, total investment income has exceeded contributions from employers and employees. This performance has helped OMERS make ad hoc increases and other enhancements to retirement benefits without requiring increased contributions.

ANNUAL INCOME
($ millions)
■ Employer/Employee Contributions ■ Investment Income*



*Investment income includes cash income from interest, dividends etc., plus gains realized upon sale of securities. It pertains to OMERS fund only and does not include income from other plans managed by OMERS.

These returns have been achieved by a broadly based investment portfolio widely diversified by region, by industry and by type of asset. This approach not only reflects the rapidly changing economic and financial environment, but also provides a balance between long and short-term investments to ensure stability, as well as flexibility.

Diversification has also been made necessary by the rapid growth of assets under management at OMERS. From a market value of roughly $2.5 billion in 1981, the fund had grown to $8.2 billion by the end of 1986. Indeed, in just the last year, the market value grew by $1.2 billion.

Over the years, we have increasingly concentrated on capital market investments, in order to take advantage of greater flexibility, greater opportunities for diversification and higher rates of return.

Our strategy of maintaining a diversified investment portfolio has stood us in good stead in light of the stormy global economic environment of 1986. Internationally, the year saw a plunge in international oil prices, major realignments of international currencies, a growing trend towards trade protectionism in the United States and western Europe and the ongoing problems of the less developed countries in paying interest on their massive debts.

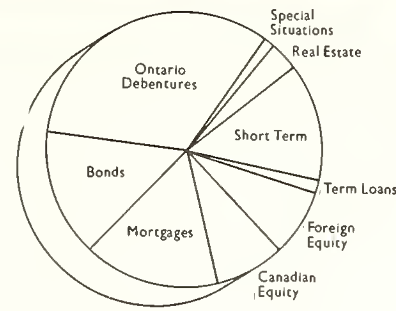
In Canada, the economic environment was somewhat calmer by comparison. Overall, the economy expanded a modest 3.1%, creating 330,000 new jobs and lowering unemployment to 9.4% by year-end. Inflation rates remained fairly steady around the 4% level and interest rates continued a downward trend.

Economic conditions were reflected in the financial markets. Both the stock and bond markets were subject to wide price fluctuations throughout the year.

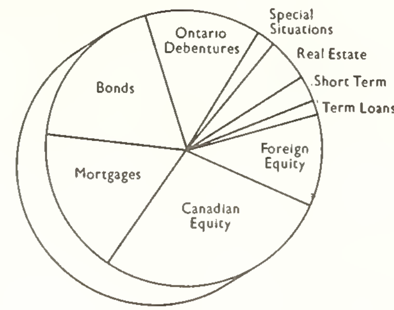
However, despite the volatility, returns on all of the major categories in our investment portfolio were well above the 4.2% inflation rate indicated by the Canadian Consumer Price Index in 1986.

EVOLUTION OF ASSET MIX

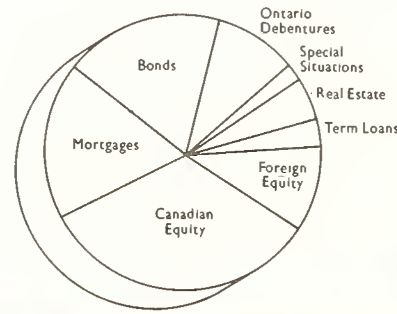
1981



1986



1990*



*Target based on anticipated growth in total assets relative to value of Non-Marketable Ontario Debentures

1986 Investment Highlights

TOTAL PORTFOLIO:
- The rate of return in 1986 was 13% — for an average annual return of 19% for the past five years

BONDS:
- Our bond portfolio (including non-marketable Ontario debentures) earned 14.8%, placing OMERS in the top third of funds measured by the SEI Performance Measurement Service
- Strong market conditions enabled us to realize $23 million in capital gains on the sale of securities.

TERM LOANS:
- The portfolio return was 15.1% in 1986, comparing favourably with a 14% return in 1985

MORTGAGES
- Fundings for the year totalled $218 million, increasing the portfolio to $1.4 billion by year-end
- At December 31st, OMERS had $632 million invested and committed in the federal government's NHA non-profit housing program, which provides affordable housing to Canadians of limited means. OMERS is a major source of funds for this valuable program
- Overall mortgage portfolio return was 12.2% for the latest year and has averaged 19.7% for the past 5 years.

EQUITIES
- Despite volatile markets, equities showed a 12% return in 1986, led by a 20.7% return in the foreign equities component
- A record $208 million in capital gains was realized on the sale of securities
- With a heavy weighting in forest products and in the oil and gas area, and a recovery in prices unfolding, the equity portfolio seems well positioned for 1987

REAL ESTATE:
- OMERS stepped up its direct investments in real estate with the completion of Constitution Square (Phase I) in Ottawa and the purchase of One University Avenue in Toronto
- Total real estate investments increased to $385 million at market from $305 million a year earlier

SPECIAL SITUATIONS
- Total funds invested or committed increased by $42 million during the year, broken down as follows:

  + $25.6 million venture capital
  − $ 3.3 million oil and gas properties
  + $19.7 million private placements

FINANCE AND ADMINISTRATION

As OMERS' pension program and assets under management have grown in recent years, so too have administrative expenses and staffing requirements.

In addition to the administration of the various pension programs, the Board is also responsible for the accounting and administrative aspects of the investment program

In 1986, administrative expenditures were $9.5 million, compared to $8.2 million in 1985. While that appears to be a substantial increase, it was well within the expenditure guidelines established by the Board with the assistance of outside advisors

These guidelines were developed to allow OMERS' resources to keep pace with growth of the fund and the pension program — ensuring a consistently high standard of performance.

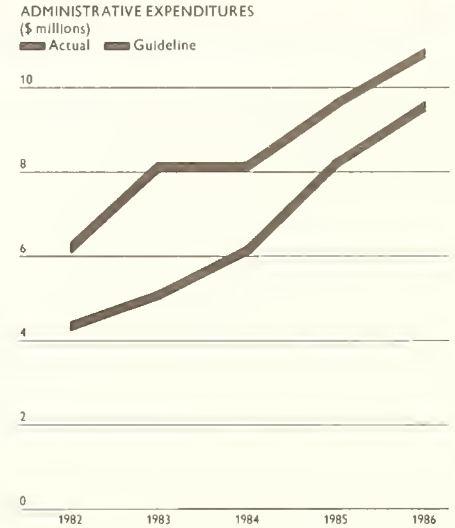
The guidelines allow for administrative expenditure that are the sum total of

- 1% of member and employer contribution to the basic OMERS plans;
- 1/10 of 1% of the year-end amortized cost of OMERS' capital market securities;
- management fees for the managed plans (OMERS manages plans for other organizations, separate and distinct from the OMERS fund. In 1986 we received $576,000 in fees for the managed plans compared to $524,000 in 1985).

For 1986, the expenditure guidelines totalled $10.7 million, so OMERS actual expenditures reached only 88% of the allowable amount. Effective financial controls have helped contain expenditure growth.

As OMERS continued to grow, the Board authorized 17 new staffing positions for a total of 142. But much of the day-to-day administration of OMERS takes place in the offices of the 1,069 participating employers — our first line of communication with members of the System.

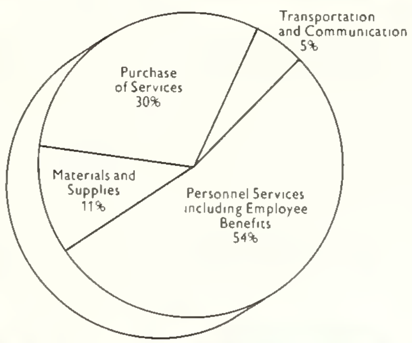
OMERS is dedicated to maintaining a high level of service while controlling staff growth and costs. To this end, we made a major commitment to automation last year when administrative systems supporting members and pensioners were converted from a computer bureau to an in-house computer.



While OMERS' expenditures have increased in recent years, they are still below the expenditure guideline — indicating effective financial controls.

This was the first step in a project to provide greatly increased support to Pension Division staff. Appropriate automation will be a key factor in OMERS' successful response to the changing pension environment

1986 ADMINISTRATIVE EXPENDITURES



OUTLOOK

As we look to the future, we have no doubt that the environment *will* change. Both the federal and the provincial governments are reviewing the ground rules for pension funds, and pension reform is an issue of increasing importance — as is indexing. Public sector funds in particular are coming under scrutiny. The Government of Ontario recently established a Public Sector Pensions Advisory Board, a Task Force on the Investment of Public Sector Pension Funds, and a Task Force on Inflation Protection for Employment Pension Plans.

OMERS' concern, first and foremost, is to protect the interests of our present and future members, and we have been active participants in the discussions and debates.

Whatever the outcome may be, we will continue to serve our membership by striving to achieve a high level of performance — and we will continue to work closely with the Government of Ontario, the municipalities and individual members as we establish new goals.

BALANCE SHEET

As at December 31, 1986 (000)	1986	1985
ASSETS:		
Investments (note 2)	$7,413,565	$6,274,012
Long term receivables (note 5)	136,306	142,553
Fixed assets (note 3)	517	764
Contributions receivable	38,884	38,229
Accrued income	66,768	56,430
	$7,656,040	$6,511,988
RESERVES AND LIABILITIES:		
Reserves for		
Basic benefits (note 4)	$6,709,121	$5,706,521
Supplementary benefits (note 5)	86,867	76,579
	$6,795,988	$5,783,100
Deposits from administered pension funds (note 6)	846,818	713,283
Accounts payable and accruals	13,234	15,605
	$7,656,040	$6,511,988

Signed on behalf of the Board

C.M. Birchard
Member

Member

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT FUND

STATEMENT OF THE RESERVES

For the year ended December 31, 1986 (000)	Basic Benefits Reserve 1986	Basic Benefits Reserve 1985	Supplementary Benefits Reserve 1986	Supplementary Benefits Reserve 1985
Balance — beginning of year	$5,706,521	$4,814,414	$76,579	$66,875
INCREASES IN RESERVES				
Contributions of				
Members	$ 220,032	$ 202,934		
Employers, current service	217,044	202,367	$ 3,998	$ 4,127
Members, unfunded liabilities		6,115		
Employers, unfunded liabilities (note 5)	8,372	41,064		
	$ 445,448	$ 452,480	$ 3,998	$ 4,127
Interest income on unfunded liabilities	12,545	12,132		
Income earned from investments	809,397	643,084	9,690	8,289
Management fees from administered pension funds (note 6)	576	524		
Transfer from supplementary benefits reserve	3,357	2,454		
Total increases	$1,271,323	$1,110,674	$13,688	$12,416
DECREASES IN RESERVES				
Members' pensions	$ 133,539	$ 108,092		
Members' contributions plus interest refunded	30,633	27,094	$ 2	
Income credited to administered pension funds (note 6)	92,852	73,707		
Administrative expenditures	9,461	8,159	41	$ 41
Transfer to other pension plans	2,238	1,515		
Transfer to basic benefits reserve for pensions at present value			3,357	2,454
Closing supplementary agreements				217
Total decreases	$ 268,723	$ 218,567	$ 3,400	$ 2,712
BALANCE — end of year	$6,709,121	$5,706,521	$86,867	$76,579

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT FUND

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NOTES TO FINANCIAL STATEMENTS

For the year ended December 31, 1986

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investments
Investments are recorded in the accounts at cost. Gains or losses on their disposal are credited or charged to income. Income from investments is recorded on the accrual basis.

Contributions
Member and employer contributions received subsequent to the year-end, but which are applicable to the current year, are recorded as receivable.

Benefits
Payments for benefits are recorded in the year in which such payments are made.

Fixed assets
Leasehold improvements and computer equipment are recorded at cost and are amortized and depreciated respectively on a straight-line basis over 5 years.

2 INVESTMENTS

Investments as defined in section 8(4) and section 8(6) of The Ontario Municipal Employees Retirement System Act are subject to the regulations of The Pension Benefits Act.

(000)	1986 Cost	1986 Market Value	1985 Cost	1985 Market Value
Short-term deposits	$ 226,067	$ 226,067	$ 131,907	$ 131,907
Bonds and debentures	2,701,959	2,752,446	2,555,184	2,537,875
Term loans	136,723	136,723	113,804	113,804
Mortgages	1,330,120	1,426,337	1,127,128	1,224,082
Equities	2,511,923	3,119,789	1,930,422	2,516,480
Real estate	348,354	385,318	275,416	305,092
Special situations	158,419	158,419	140,151	140,151
	$7,413,565	$8,205,099	$6,274,012	$6,969,391

Bonds and debentures include $1,293,025,000 (1985 — $1,293,025,000) of Province of Ontario debentures bearing a weighted average interest rate of 9.07% and maturing at various dates beginning on December 31, 1993 through to December 31, 2006.

Market value is quoted value for bonds, debentures, and equities. Market value for Ontario Debentures and mortgages is computed based on market yields.

Market value for real estate is appraised value as provided by our property managers.

Market value for term loans and special situations has been assumed to equal the cost due to the nature of the investment.

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT FUND

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3. FIXED ASSETS

(000)	1986			1985
	Cost	Accumulated depreciation & amortization	Net	Net
Leasehold improvements	$ 487	$449	$ 37	$166
Computer equipment	830	350	480	598
	$1,317	$799	$517	$764

4. BASIC BENEFITS RESERVE

The basic benefits reserve is maintained for the payment of pensions to retired members or their beneficiaries and the future payment of pensions and benefits to contributing members and to terminated members who have elected a deferred pension.

The latest actuarial valuation of the Fund dated January 1, 1986 determined the total actuarial liabilities of the Fund for basic benefits to be $5,394,318,000 using the unit credit cost method. The actuarially adjusted book value of accumulated assets at that date was $5,962,870,000 resulting in an actuarial surplus of $568,552,000.

The results of the actuarial valuation projected to December 31, 1986, indicate that the existing levels of member and employer contributions are sufficient to meet the cost of benefits earned from January 1, 1986 to December 31, 1986.

5. SUPPLEMENTARY BENEFITS RESERVES

Under the terms of The Ontario Municipal Employees Retirement System Act various participating employers have entered into agreements with the Board for the provision of supplementary benefits. The supplementary reserves represent the net assets available for payment of benefits under the agreements. Each employer is responsible, individually, for the funding of such benefits.

Effective January 1, 1983 all assets and liabilities with respect to prior service agreements were transferred to the supplementary reserve. On the same date, the assets and liabilities of most supplementary agreements were then transferred to the basic OMERS plan.

Where the assets transferred from the previous agreements were not sufficient to provide for the liabilities, the unfunded amounts were identified and are being paid off by the participating employers. Such unfunded liabilities are now recorded in the basic benefits reserve and are offset by a long-term receivable from the participating employers, to be paid, with interest, over a period not to exceed 15 years. For any previous agreements where the assets were in excess of liabilities, the resulting surplus was refunded to the participating employers.

Supplementary agreements entered into by employers with the Board subsequent to January 1, 1983 are subject to a final determination of the actuarial liability for benefits under each agreement. The liabilities determined under each new supplementary agreement are recorded in the basic benefits reserve and are offset by a long-term receivable from the participating employers with repayment terms similar to those stated above.

6. ADMINISTERED PENSION FUNDS

The administered pension funds which form part of the Fund and which are administered on behalf of the Ontario Council of Regents for Colleges of Applied Arts and Technology, the Ryerson Polytechnical Institute, the members of the Legislative Assembly as represented by the Board of Internal Economy — The Caucus Employees Retirement Fund (until June 30, 1986) and the Minister of Energy for the Province of Ontario (The Ontario Hydro Guarantee Fund) are credited with amounts which are equal to the income earned by the Fund from the investment of the monies deposited in the Fund by the administered pension funds. The Ontario Municipal Employees Retirement Board is authorized under the terms of the various management agreements to recover its expenses for administering the aforementioned plans.

Order in Council #889/86 April 3, 1986 revoked Order in Council 3573/77 dated December 21, 1979, which appointed OMERS Board as Trustee of the Caucus Employees Retirement Plan. The revocation became effective June 30, 1986.

On July 10, 1986 the sum of $3,250,000 was transferred to the Ontario Public Service Superannuation Fund. As at December 31, 1986 deposits from administered pension plans include $889,000 representing the remaining Caucus funds to be transferred with interest in 1987.

7 COMMITMENTS

Total investment commitments outstanding at December 31, 1986 amounted to approximately $420 million of which $297 million relates to mortgages, $38 million to real estate, $10 million to bonds and debentures, $15 million to term loans and the remaining $60 million to venture capital and other.

AUDITORS' REPORT TO THE ONTARIO MUNICIPAL EMPLOYEES RETIREMENT BOARD

We have examined the balance sheet of the Ontario Municipal Employees Retirement Fund as at December 31, 1986 and the statement of the reserves for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the Fund as at December 31, 1986 and the results of its operations for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year

Coopers & Lybrand

Chartered Accountants, March 31, 1987

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT BOARD ACTUARIAL COST CERTIFICATE
as at December 31, 1986

The most recent actuarial valuation of the Ontario Municipal Employees Retirement System was conducted as at January 1, 1986 using the Unit Credit Actuarial Cost Method, with projection of earnings. Our valuation conformed with the Recommendations for the Valuation of Pension Plans adopted by the Canadian Institute of Actuaries.

The results of the actuarial valuation disclosed total Actuarial Liabilities of $5,394 318 million in respect of benefits accrued for service prior to January 1, 1986. The Actuarial Assets at that date were $5,962 870 million indicating an actuarial surplus or Funding Excess of $568 552 million.

The results of the actuarial valuation also indicated that the existing levels of employee and employer contributions are sufficient to meet the Normal Actuarial Cost of benefits to be earned each calendar year until the next actuarial valuation is performed.

We are of the opinion therefore, in accordance with generally accepted actuarial principles, that the assets of the Fund at December 31, 1986 are sufficient to meet all the liabilities of the Plan in respect of services rendered by members up to that date

Martin Brown

THE WYATT COMPANY, Martin J K Brown, F I A Fellow, Canadian Institute of Actuaries
February 27, 1987

SCHEDULE OF ADMINISTRATIVE EXPENDITURES

For the year ended December 31, 1986 (000)	1986	1985
PERSONNEL SERVICES INCLUDING EMPLOYEE BENEFITS		
Salaries of regular staff	$4,233	$3,584
Salaries of casual staff	246	200
Pensions	306	255
Employee benefits	306	272
	$5,091	$4,311
TRANSPORTATION AND COMMUNICATION		
Travel	$ 227	$ 189
Telephone	176	154
Postage and express	111	105
	$ 514	$ 448
PURCHASE OF SERVICES		
Actuarial	$ 135	$ 125
Audit	102	84
Medical	32	23
Legal	280	28[illegible]
Other professional	492	392
Recruitment and training	71	46
Office rental	1,232	746
Computer processing	182	796
Equipment maintenance	109	34
Insurance	7	6
Board's services	112	127
Research and information	135	153
	$2,889	$2,815
MATERIALS AND SUPPLIES		
Furniture and equipment purchases	$ 272	$ 134
Supplies and stationery	223	178
Publications for members and employers	88	73
Office alterations	9	8
Amortization of leasehold improvements	216	83
Depreciation of fixed assets	200	150
	$1,008	$ 626
Total Expenditures	$9,502	$8,200

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FIVE YEAR REVIEW OF FINANCIAL DATA

(000)	1986	1985	1984	1983	1982
*Investments at cost					
Provincial debentures	$1,293,025	$1,293,025	$1,293,025	$1,293,025	$1,293,025
Marketable securities	6,120,540	4,980,987	3,988,824	3,075,543	2,440,504
	$7,413,565	$6,274,012	$5,281,849	$4,368,568	$3,733,529
*Reserve for					
Basic benefits	$6,709,121	$5,706,521	$4,814,414	$4,070,275	$3,191,720
Prior service agreements	—	—	—	—	4,361
Supplementary benefits agreements	86,867	76,579	66,875	64,594	190,304
Managed plans	846,818	713,283	597,789	499,299	413,160
	$7,642,806	$6,496,383	$5,479,078	$4,634,168	$3,799,545
Investment income earned					
Basic plan	$ 716,545	$ 569,377	$ 457,582	$ 371,133	$ 298,605
Prior service agreements	—	—	—	—	225
Supplementary benefits agreements	9,690	8,289	7,036	6,715	17,704
Managed plans	92,852	73,707	60,060	47,192	39,341
	$ 819,087	$ 651,373	$ 524,678	$ 425,040	$ 355,875
Contributions received for					
Basic plan	$ 437,076	$ 405,301	$ 380,769	$ 361,937	$ 336,368
Basic plan unfunded liabilities	20,917	59,311	21,329	134,315	—
Prior service agreements	—	—	—	—	32
Supplementary benefits agreements	3,998	4,127	3,172	4,069	41,504
	$ 461,991	$ 468,739	$ 405,270	$ 500,321	$ 377,904
Payments to members					
Pensions paid	$ 133,539	$ 108,092	$ 86,858	$ 69,315	$ 55,304
Contributions and interest refunded	30,635	27,094	23,377	26,115	16,064
Transfers to other plans	2,238	1,515	1,548	1,347	1,619
	$ 166,412	$ 136,701	$ 111,783	$ 96,777	$ 72,987
Administrative expenditures and recoveries					
Pension program					
Gross	$ 4,202	$ 3,573	$ 3,461	$ 2,959	$ 2,721
Fee recoveries	617	565	505	513	832
Net	$ 3,585	$ 3,008	$ 2,956	$ 2,446	$ 1,889
Investment program	5,300	4,627	2,656	2,330	1,641
	$ 8,885	$ 7,635	$ 5,612	$ 4,776	$ 3,530
Total fund annual rates of return					
Dollar-weighted return on book value	12.4%	11.7%	11.2%	10.7%	10.8%
Time-weighted return on market value	13.0%	23.6%	11.0%	15.7%	33.1%
Unaudited figures					

*The amount shown for each year as at December 31 is cumulative

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FIVE YEAR REVIEW OF SELECTED DATA

	1986	1985	1984	1983	1982
*Employers					
Municipalities	507	504	493	490	491
School boards	132	133	133	133	129
Other local boards	430	426	426	423	422
	1,069	1,063	1,052	1,046	1,042
*Members contributing, employed by					
Municipalities	71,703	69,469	67,024	65,588	64,510
School boards	36,158	34,568	33,253	32,536	32,027
Other local boards	32,259	31,061	30,168	29,725	29,584
	140,120	135,098	130,445	127,849	126,121
*Members contributing					
Female	56,252	52,880	50,005	48,287	46,924
Male	83,868	82,218	80,440	79,562	79,197
	140,120	135,098	130,445	127,849	126,121
*Normal retirement age 65	122,952	116,937	112,704	110,343	108,855
*Normal retirement age 60	17,168	18,161	17,741	17,506	17,266
	140,120	135,098	130,445	127,849	126,121
*Terminated members who have elected a deferred pension	3,688	3,805	3,786	3,721	3,710
*Number of pensioners by type of pension					
Normal retirement	17,291	16,358	15,218	14,386	13,442
Early retirement	6,611	5,719	4,841	4,034	3,341
Disability retirement	1,940	1,843	1,705	1,603	1,473
Spouses and children	7,498	6,961	6,387	5,590	5,031
	33,340	30,881	28,151	25,613	23,287
*Total membership comprising Contributing members, deferred pensions and pensioners	177,148	169,784	162,382	157,183	153,118
Number of members enrolled each year	15,563	14,694	11,436	9,901	11,764
Number of members terminated each year	10,541	10,041	8,840	8,173	8,680
Net increases in membership	5,022	4,653	2,596	1,728	3,084

Unaudited figures

*Cumulative totals at year-end

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OFFICERS AND DIRECTORS

ONTARIO MUNICIPAL EMPLOYEES RETIREMENT BOARD
as at December 31, 1986

Mr S. P. Dobbin, *Chairman,*
Stationary Engineer,
Toronto Board of Education

Mr E. W. Matthews, *Vice-Chairman,*
Member, Lower Trent
Conservation Authority

Mr. T. D. Allan,
Police Officer, Durham Regional Police Force

Mr. C. M. Beckstead,
Chief Administative Officer, City of Nepean

Mr. C. R. Bernardi,
Director of Personnel and Labour Relations,
City of Sault Ste Marie

Mr P. R. Burke,
Firefighter, City of Windsor

Mrs. O. V. Dryden,
Commissioner — Public Utilities Commission
City of London

Miss D. F. Graber,
Administrative Supervisor, Department of Roads and Traffic, Municipality of Metropolitan Toronto

Mr D. S. McColl,
Assistant Deputy Minister,
Ministry of Treasury and Economics

Mr. A. J. Roberts,
Consumer Relations Representative,
St Catharines Hydro Electric Commission

SENIOR STAFF

Mr. A. W Reeve,
Executive Director

Mr P. L. Baxter,
Director of Investments

Mr A. Trafford,
Director of Pension Administration

Mr C Massouras,
Director of Finance and Administration

INVESTMENT POLICY COMMITTEE OF THE BOARD
as at December 31, 1986

Mr. R. M. MacIntosh, *Chairman,*
Canadian Banker's Association

Mr. J. C. C. Wansborough, *Vice-Chairman,*
The National Victoria and
Grey Trust Company

Mr. H. M. Cunningham,
Cockfield, Cooper, Cunningham
Investment Counsel Inc.

Mr. N. J Short,
Guardian Capital Group Limited

Mr S. P. Dobbin,
Chairman of the Board

Mr C. M. Beckstead,
Member of the Board

Mr E. W Matthews,
Member of the Board

Mr A. W. Reeve,
Executive Director

Mr P. L Baxter,
Director of Investments

ADVISORS TO THE BOARD

Mr M J. K. Brown, F. I. A.
The Wyatt Company, Actuary

Dr Alexander Roberts,
Medical Advisor

Mr Maurice Coombs,
Osler, Hoskin & Harcourt, Legal Advisor

Coopers & Lybrand
Auditors

APPENDIX N

AGENCIES, BOARDS AND COMMISSIONS THAT CONTRIBUTE TO THE PSSF as of June 1987

		Members
1.	Alcoholism and Drug Addiction Research Foundation	604
2.	Algonquin Forest Authority	23
3.	College Relations Commission	13
4.	Education Relations Commission	13
5.	Farm Income Stabilization Commission of Ontario	None
6.	Housing Authorities Created Under the Housing Development Act	2,375
7.	Legislative Offices	816
8.	Liquor Control Board of Ontario, and	3,483
9.	Liquor Licence Board of Ontario	
10.	Niagara Parks Commission	307
11.	Niagara Escarpment Commission	34
12.	Office of the Ombudsman	122
13.	Office of the Provincial Auditor	73
14.	Ontario Arts Council	50
15.	Ontario Development Corporation	144
16.	Ontario Energy Board	38
17.	Ontario Highway Transport Board	235
18.	Ontario Housing Corporation	272
19.	Ontario Human Rights Commission	92
20.	Ontario Labour Relations Board	104
21.	Ontario Lottery Corporation	252
22.	Ontario Municipal Board	32
23.	Ontario Place Corporation	102
24.	Ontario Racing Commission	56
25.	Ontario Science Centre	215
26.	Ontario Securities Commission	117
27.	Ontario Waste Management Corporation	40
28.	Pension Commission of Ontario	34
29.	Residential Tenancy Commission	30
30.	St. Lawrence Parks Commission	205
31.	Teachers' Superannuation Commission	104
32.	Toronto Area Transit Operating Authority	570
33.	Workers' Compensation Appeals Tribunal	53

GLOSSARY

The Task Force has made every effort to define and explain all terms used in its report as they occur. This Glossary explains a number of specialized words and phrases.

In part, the Glossary has been adapted from the Report of the Royal Commission on the Status of Pensions in Ontario (1980) and the Pensions Benefit Act, 1987.

ACCRUAL – The recognition of change in either assets or liabilities which has transpired over a period of time but which did not involve an explicit cash transaction.

ACTIVE PLAN MEMBERS – Employees who are currently working and who are members of a pension plan.

ACTUARIAL ASSUMPTIONS – The assumptions which actuaries adopt about future experience in order to estimate the future cost of pension benefits, including assumptions as to mortality rate, employee turnover, compensation levels and investment earnings.

ACTUARIAL SURPLUS – An actuarial surplus is the surplus that results from actual experience being better than what the actuary assumed.

ACTUARIAL VALUATION – The periodic estimation or valuation by an actuary of the present value of future benefits to be paid under a pension plan and of the assets held by the pension fund. On the basis of the difference between these two amounts, the actuary may recommend changes in the contribution rate.

ACTUARY – A professionally trained specialist in the pension and insurance fields. In Canada, full professional recognition requires membership in the Canadian Institute of Actuaries.

AD HOC ADJUSTMENT – Amount added to a pension after retirement, on an irregular basis and not as a result of a prior commitment or contract. To be distinguished from indexing.

ANNUITY – Periodic payments (usually monthly) provided by the terms of a contract for the lifetime of an individual (the annuitant); may be a fixed or varying amount, and may continue for a period after the annuitant's death.

ASSET MIX – The mix of assets refers to the proportions of various types of investments held by a pension fund, usually expressed as the percentage of investments held in bonds, equities, real estate, etc.

ASSETS – The investments or cash held by a pension fund. These investments include equities and bonds traded on the capital markets, mortgages, real estate, venture capital, non-market government debt and private placements.

BENEFICIARY – In respect of a trust fund, the person(s) in whose interest the trust is established and who is (are) to benefit from it. Also used to refer specifically to a person who, on the death of a plan member or pensioner, may become entitled to a benefit under a pension plan.

BENEFIT – Generally, any form of payment to which a person may become entitled under the terms of a pension plan; often refers specifically to the normal pension provided by the plan benefit formula.

BENEFIT FORMULA – Provision in a pension plan for calculating a member's defined benefit according to years of service, earnings (career or final average), a fixed dollar amount, etc.

BEST EARNINGS FORMULA – A defined benefit formula which applies the unit of benefit credit for each year of service to the member's average earnings for a specified period of highest earnings (e.g., best five of the last ten years of service).

BOND – A certificate to show evidence of debt. The term usually implies that specific assets have been pledged as security.

BOOK VALUE – The amount shown in the books as the cost of an asset. Usually refers to the price paid for an asset.

CANADA PENSION PLAN (CPP) – A national mandatory, earnings-related pension plan, introduced together with the Quebec Pension Plan (QPP) in 1965, for all working Canadians between the ages of 18 and 70. It is financed on a partial pay-as-you-go basis with only a small asset base relative to future liabilities.

CAREER AVERAGE FORMULA – A defined benefit formula which applies the unit of benefit to earnings of the member in each year of service, and not to final or final average earnings.

CASH FLOW – The total flow of funds in a given period. Calculated in the following manner: cash inflows (contributions and interest) minus cash outflows (benefit payments and operating expenses) = cash flow .

CASH OR NEAR CASH – Those pension assets held in cash or in assets such as treasury bills or short-term deposits, which can be converted to cash quickly.

COMMUTED VALUE – The value calculated in a prescribed manner and as of a fixed date of a pension, a deferred pension, a pension benefit or an ancillary benefit.

CONTRIBUTORY PLAN – A pension plan which requires the employees to make contributions by payroll deduction in order to qualify for benefits under the plan.

COST CERTIFICATE – The certificate of an actuary, based on an actuarial valuation, setting out costs and contributions required under an employment pension plan. Under pension benefits legislation a cost certificate must be filed when a plan is established and at least every three years thereafter, and when the plan is amended.

DEBENTURE – A form of long-term debt which is not secured by the pledge of specific assets

DEFICIT – An amount determined by an actuary when the present value of estimated future pension liabilities is more than current assets. A deficit can arise from:

- past service liability, which usually occurs when the plan benefits are improved; or
- an experience deficiency, which can arise when actual experience differs from the actuarial assumptions.

(See also Experience Deficiency and Unfunded Liability)

DEFINED BENEFIT PLAN – A plan which defines the pension to be provided (based on service, average earnings, etc.) but not the total contributions. If plan is contributory, the rate of employee contributions may be specified, with the employer paying the balance of cost. To be distinguished from defined contribution plan.

DEFINED CONTRIBUTION (MONEY PURCHASE) PLAN – Plan which defines contributions to be made by employer and employees, but not the benefit formula. Accumulated contributions and interest are used to purchase an annuity for the member (ie: the pension is <u>asset</u> related). To be distinguished from defined benefit plan.

ECONOMIC ENHANCEMENT – A positive impact on the economy due to the investment of pension funds. There are various specific methods advocated for achieving this, such as:

- investing through the capital markets, achieving economic benefits as a secondary objective to a primary rate of return goal

- deliberately conferring a subsidy (through a lower rate of return) on investments which are judged to contribute to economic enhancement.

EMPLOYER/SPONSORED PENSION PLAN – A pension plan offered by an employer or supported by a group of employers for the benefit of employees.

EQUITY – A form of investment which involves ownership (e.g.: stocks, real estate, venture capital).

EXPERIENCE DEFICIENCY- An unfunded liability, revealed by an actuarial review of a pension plan, resulting from a difference between actual experience (investment earnings, salary levels, etc.) and assumptions made at the time of a previous valuation.

EXPERIENCE GAINS AND LOSSES (ACTUARIAL GAINS AND LOSSES) – Deviations between actual experience up to the valuation date and the actuarial assumptions previously used. Such deviations result in experience gains when actual experience is more favourable than that previously assumed or experience losses when actual experience is less favourable than that previously assumed.

FINAL EARNINGS FORMULA – A defined benefit formula which applies the unit of benefit credited for each year of service to the member's final salary rate or annual earnings immediately before retirement. A form of Best Earnings Formula.

FLAT BENEFIT FORMULA – A defined benefit formula which specifies a dollar amount of pension to be credited for each year of service.

FULLY FUNDED – Term describing a plan which, at a given time, has sufficient assets to provide for all pensions and other benefits in respect of service up to that date.

FUNDING – Systematic employer and/or employee contributions into a pension fund which, with investment earnings, are expected to provide for all pensions and other benefits as they become payable.

GOING CONCERN BASIS – Refers to the assumption, when making an actuarial valuation, that the pension plan will continue in operation indefinitely. (Opposite of plan termination or wind-up basis.)

HYBRID – A type of pension plan which promises a pension benefit equal to the greater of:

- a minimum guaranteed pension benefit
- employee and employer contributions plus investment earnings.

IMPUTED MARKET VALUE – The computed value of a non-market asset, based on the yield of a similar asset which is traded in the marketplace.

INDEXING- Provision for periodically adjusting a benefit amount (usually after retirement) according to a formula based on a recognized index of price or wage levels, e.g., the Consumer Price Index or on some other basis. To be distinguished from ad hoc adjustment.

INSURED PENSION PLAN – A pension plan in which all benefits are purchased from and guaranteed by an insurance company as contributions are received.

INTEGRATION – Provision in a pension plan which relates plan contributions and/or benefits to those of a government pension program, e.g. Canada Pension Plan.

INTEREST ASSUMPTION – The actuarial assumption as to the return to be earned on funds invested, or to be invested, to provide for future pension benefits. In calling the return interest, it is recognized that, in addition to interest on debt securities, the earnings of a pension fund may include items such as dividends on equity securities, rentals on real estate, realized and unrealized gains or (as offsets) losses on fund investments. The actuary uses the interest assumption to discount future liabilities to calculate their present value.

INVESTMENT MANAGEMENT – The management of a pension fund's investments; consists of two parts – the formulation of investment policy and the implementation of this policy.

INVESTMENT POLICY – The level of risk the pension fund governors are prepared to assume; it is most often expressed as an asset mix policy and a financial rate of return goal.

INVESTMENT RETURN (YIELD) – Actual earnings of a pension fund including interest on fixed income securities (bonds, mortgates, etc.) dividends, capital gains, etc., normally expressed as a percentage of assets.

INVESTMENT RISK SURPLUS – The difference between the actual investment return and the investment return that would have resulted if the pension fund governors had selected an investment policy that was essentially risk free.

LIQUIDITY – Refers to the ease with which an investment can be converted to cash or near-cash. For example, publicly traded stocks are very liquid while real estate is less so.

MARKET INVESTMENTS – Assets which can be bought and sold in a secondary market. They include highly liquid assets such as stocks and bonds, and less liquid assets such as real estate, mortgages, venture capital and private placements.

MARKET VALUE – The value of an asset set in the marketplace, given a willing buyer and a willing seller.

MONEY PURCHASE PLAN – See Defined Contribution Plan.

MULTI-EMPLOYER PLAN – A pension plan covering employees of more than one employer, usually by agreement with a union or group of unions and usually offering a defined contribution plan converted to a defined benefit on retirement. Note that OMERS and HOOPP are multi-employer plans of another type; they are not tied to a union and offer a defined benefit plan.

NON-CONTRIBUTORY PLAN – A pension plan in which all required contributions are made by the employer.

NON-MARKET GOVERNMENT DEBT – Refers to investments of certain pension funds in government debt with specified terms. Whether held as debentures or as book entries, such debt may not be bought or sold in a secondary market.

OLD AGE SECURITY (OAS) – Federal program providing a universal, flat rate pension to all residents aged 65 and over, regardless of need; also provides income-tested supplements.

PAY-AS-YOU-GO PLAN – Term used for benefits that are not funded except as and when they are paid to individuals, ie. payment is made from current revenue or other sources outside the plan as such (also known as Pay-Go Plan). A modified pay-as-you-go plan has a small fund but is not fully funded.

PENSION – Generally, any regular periodic payment to a person who has retired from the service of an employer or has met certain age or other conditions for payments under a government pension program.

PENSION BOARD (COMMITTEE) – Group of persons designated according to the terms of a pension plan to oversee various administrative functions. Members may be <u>trustees</u> of the fund.

PENSION COMMISSION OF ONTARIO – Commission responsible for administering the Ontario Pension Benefits Act.

PENSION DEAL – The statement of the pension promise by an employer to an employee and the means by which that promise will be fulfilled.

PENSION FUND – The assets which are accumulated and held separately in order to pay for the pension benefits promised.

PENSION FUND GOVERNORS – The persons who have overall responsibility for, and decision-making powers in respect of, a pension fund.

PENSION PLAN – A plan organized and administered to provide a regular income for the lifetime of retired members; other benefits that may be provided include payments on permanent disability, death, etc.

PLAN MEMBER – A contributor to a pension fund (active member), a recipient of a pension (retiree/beneficiary) or a person who is no longer contributing but is entitled to a pension in the future (deferred member).

PLAN TERMINATION – Discontinuance of an employment pension plan, voluntary or involuntary (e.g. as in bankruptcy); wind-up procedure regulated by pension benefits legislation.

POOLED FUND – Assets of two or more pension plans, held by pension investment organization and combined for investment purposes in a single fund, each plan sharing pro rata in the net income from investments.

PORTABILITY – Extent to which an individual is provided on retirement with pension income which recognizes all periods of employment with various employers.

PORTFOLIO – The collection of investments held by a pension fund.

PRESENT VALUE – Amount of money which, if invested today at a given rate of compound interest would provide a defined benefit commencing at a specified future date.

PRIVATE SECTOR PENSION PLAN – An employment pension plan offered by an employer or by employers and unions (multi-employer plan) in the private sector.

PUBLIC SECTOR PENSION PLAN – Pension plans covering employees of governments and public agencies but does not include the Canada Pension Plan.

RATE OF RETURN – The investment yield (return) from investments of a pension fund, including interest on fixed income securities, dividends, capital gains, etc.

REGISTERED PENSION PLAN – An employment pension plan accepted for registration for tax purposes under the Income Tax Act, and/or for registration under applicable pension benefits legislation.

REGISTERED RETIREMENT SAVINGS PLAN (RRSP) – A personal retirement savings plan, defined in the Income Tax Act, under which tax is deferred on contributions and investment income until received as annuity payments.

RETIREMENT – Withdrawal from the active work force because of age; may also be used in the sense of permanent withdrawal from the labour force for any reason, including disability.

RISK – Five kinds of risk which are important to a pension fund are:

Default Risk – The risk that investments held by a pension fund will go into default; for example, that the issuer of a bond will not pay the principal and interest when it is due.

Market Volatility Risk – The risk associated with variations in the market value of investments. The market volatility risk of a portfolio can be reduced by diversifying among different types of investments, different industries, regions, etc.

Inflation Risk – Inflation risk refers to the impact that unanticipated inflation can have on the market values of investments relative to the liabilities of the pension fund.

Liquidity Risk - Liquidity risk reflects the cost of being unable to react to either anticipated or unanticipated circumstances which would require investments being converted to cash or near cash.

Independent Return Risk – The risk that the liabilities of the pension fund will change in ways that do not match the investments.

SEGREGATED FUND – Assets of a pension plan managed by a pension investment organization and segregated from the other assets managed by the organization.

SHARED RISK/SHARED REWARD PLAN – A type of pension plan in which the burden of a deficit and the advantage of a surplus both are shared by plan members and the employer, normally by varying contribution rates, varying benefit improvements, or similar means. This type of plan combines elements of defined benefit related and asset related plans.

SOCIAL INVESTING – Refers to adopting social or ethical goals in addition to the rate of return objective in pension fund investing. May or may not entail accepting a lower, or concessionary rate of return. (See also Economic Enhancement.)

SURPLUS – An amount determined by an actuary when the present value of estimated future pension liabilities is less than current assets of the pension fund. (See also Actuarial Surplus and Investment Risk Surplus).

TAX DEFERRAL – Provision in the Income Tax Act whereby certain pension and similar contributions are tax-deductible and employer contributions and investment income are not included in a member's current taxable income; but benefit payments are considered income for tax purposes in the year in which they are received.

TEN PERCENT FOREIGN INVESTMENT RULE – The Income Tax Act requires that no more than 10% of pension fund assets be in foreign property to qualify for tax-free treatment.

TRUST AGREEMENT – An agreement setting out the duties and responsibilities of a trustee or trustees under a pension plan.

TRUSTEED PENSION PLAN – An employment pension plan whose funds are held and normally invested by trustees, and the plan sponsor is responsible for making sufficient contributions to maintain the plan's solvency.

UNFUNDED LIABILITY (UNFUNDED ACTUARIAL LIABILITY) – Generally, any amount by which the assets of a pension plan are less than its liabilities. Sometimes used to refer to a situation when the liability is due to the cost of improved benefits.

VENTURE CAPITAL – Capital invested or available for investment in the ownership element of new, small to medium size, enterprises.

VESTING – The right of an employee, on termination of employment, to part or all of his or her accrued pension; usually requires locking-in of employee's contributions.

WINDING-UP (OR WIND-UP) – See Plan Termination

YEAR'S MAXIMUM PENSIONABLE EARNINGS (YMPE) – Term used in Canada Pension Plan, often referred to as the earnings ceiling; the maximum amount of annual earnings from employment on which CPP contributions and benefits are calculated. YMPE is calculated each year according to a formula related to average industrial wage levels.

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In whose interest?

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